Causes of China's current economic development pattern

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At the beginning of the 21st century, China's economy entered a period of rapid growth and current economic development pattern was formed. Despite the rapid growth of the economy, the current development pattern has caused divergence from the aim of development, stagnation of the means of development, and distortion of the drivers of development. The cause of the current economic development pattern is one where market-oriented reforms are pushing local governments to shift roles from profit entities to market entities, but local governments are failing to undertake the responsibilities of the market and have been exceeding their authority, ignoring their roles, or misplacing their efforts for some time. If the current economic development pattern is not changed, China could either fall into the "middle-income trap" or the "resource-exhaustion trap."

Keywords: economic development pattern, government, institutional reform

1. The development-stage causes of the current economic development pattern

The economic development pattern pegged for transformation in the report from the Seventeenth CPC National Congress, refers to an economic development status where the aggregate demand structure, supply structure, and factor inputs structure have become imbalanced. This economic development pattern was formed in the beginning of the 21st century and continues to this day. It may cease to exist in the next few years due to the difficulty of sustaining it, or it may be transformed into a new pattern of economic development through active adjustment. In addition, transforming the economic development pattern is also a significant adjustment to the guidelines of "Recommendations for the Ninth Five-year Plan" and the principle of "advancing the transformation of the economic growth pattern," both of which were put forward in 1995.

1.1. A review of the transformation of economic growth pattern

There are two types of economic growth pattern: extensive and intensive. The former promotes economic growth mainly by increasing the input of capital and resources in production, whereas the latter boosts the economy by improving the quantity and quality of products through

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technical achievements and raising the overall quality of workers. The transformation of the economic growth model thus refers to the change from extensive to intensive. This is affected by both the stage of economic development and the economic system.

The concept of changing the model of economic growth proposed in the "Recommendations for the Ninth Five-year Plan" originally came from former Soviet Union. To keep the economic growth rate from falling and improve economic performance, in 1971 the 24th Congress of the Communist Party of the former Soviet Union officially proposed that the Soviet economic growth model should be transformed to one of intensive growth (Jing & Lang, 2011). The basis of the transformation of economic growth model in the Soviet Union came from Karl Marx, who in the 1860s when the agriculture in North America was still under extensive operation, observed that there were already two types of growth pattern in the United Kingdom. By then, capital began to take the place of land and labor, which were lacking after the establishment of the ownership of land in the U.K., which is the origin of Differential Rent II[1].

We know that in a market economy there are stable and multiple methods of combining the factors of production of the inputs and outputs of each product. Such combinations of approaches are so-called production functions, which are determined by established technologies. The various factors of production are replaceable, which is the reason people can choose the approach with the lower cost in production. And when the prices of such factors change, a new approach is sought. Early intensive operation replaced the massive input of land and labor with capital, which was abundant compared with limited land and labor. This is in fact the reason that allocating resources through market competition and market-oriented methods is superior to other modes of production. This phenomenon has been illustrated from the classical economic school represented by Smith to the Neo-classical economic school represented by Marshall and then to the Neo-classical synthesis represented by Samuelson (1981).

The postwar development economics holds that with industrialization and increasing wealth, the prices of the factors of production change according to certain rules. First, land (or natural resources) and labor become increasingly expensive and capital becomes cheaper and cheaper. The production model will thus evolve from resource- and labor-intensive to capital-intensive. When technical progress and innovation become the major sources of wealth, merely inputting capital becomes less efficient than investments in human capital. As a result, the production model will evolve from capital-intensive to technology-intensive or capital- and tech-intensive (Tan, 1986; Lin, 2010). The entire process of industrialization is the process of intensive operation replacing extensive operation. Thus it can be seen that the transformation of the economic growth model is a spontaneous process derived from the market economy, and it requires no intervention of the government.

However, for the Soviet Union, it was a totally different scenario under the planned economy. Due to the lack of a pricing mechanism or competitive mechanism, it was difficult to make comparison among factors of production and there was no theoretical basis for replacement.

[1] Karl Marx. (1975). *Das Kapital* (*Volume 3*). People's Publishing House, 759-771. (In Chinese)

Under the planned economy with macro-and micro-integration, "enterprises" were merely a chessman of the state, and lacked motivation for reform or the ability to self-evolve. When planners realized the labor force was about to dry up and there was severe waste in the means of production, the state attempted to promote the transformation of the economic growth model from the macro level. For example, former Soviet Union substantially increased funding for scientific research, intensified training for technical cadres and management cadres, adjusted traditional investment policies, promoted technical renewal and transformation, gave priority to the development of technology-intensive sectors such as machine manufacturing, strived to develop energy-efficient industries, and enlarged the rights of self-management of local governments and enterprises (Ge, 1997). However, such efforts produced little effect until the dissolution of the Soviet Union when the planned economy finally gave way to entities that allocated resources in accordance with the market. The subsequent "shock therapy" was a much more "extensive" measure resulting from desperation to adopt a market economy, which was disastrous for the country.

"Recommendations for the Ninth Five-year Plan" were made in the context of the transformation from a planned economy to a market economy. Although China proposed shifting to an economic development path focused on improving economic efficiency in the Sixth Five-year Plan in the early 1980s, the excessive pursuit of output and growth persisted, the extensive economic growth model dominated, and increasing GNP mainly required input of production factors (natural resources, capital, and labor). There was no essential change in this situation until the mid-1990s. To cope with this situation, the "Recommendations for the Ninth Five-year Plan" proposed actively promoting the transformation of the economic growth model and focusing on economic efficiency. In other words, this was still "external" regulation applied to an economy lacking a market mechanism to enterprises lacking motivation for intensive operation. But soon after that, China came across an objective environment favorable to rapid economic growth.

1.2. China's economic development enters a new phase in the 21st century

China's economy experienced a period of rapid growth in the 21st century. Internationally, the United States, attempting to recover from the shock of the September 11, 2001 attacks, implemented policies to stimulate the real estate industry, thus encouraging global economic recovery. The recovered economy soon shot into the fast lane and beginning in 2003 the world economy achieved five consecutive years of growth between 4.1 and 5.4 percent, which was quite rare over the previous 30 years. The rapid growth of the world economy drove the development of world trade whose growth rate hit a historical 21.6 percent in 2004[1].

Domestically, to achieve a soft landing and prevent inflation, China carried out relatively tight monetary policy for quite a long time after 1993. Constraints to demand, especially constraints to

[1] Reference to the annual *International Statistical Yearbook.*

consumption, increased, and in the mid to late 1990s there appeared buyer's market for "consumer goods," which reflected a Chinese economy that had achieved an initial transformation to market economy. After the Asian Financial Crisis in 1997, China strengthened construction of infrastructure and basic industry through government bond investment, which increased the supply capacity. In the meantime, after 20 years reform and opening up, China had become more competitive internationally, and the relatively stable exchange rate enhanced its ability to export goods. Furthermore, China's entry into the WTO in the beginning of the 21st century brought about a more relaxed international environment, which created opportunities for the expansion of exports.

It was in such an international and domestic context that China's economy achieved five consecutive double-digit annual increases after 2003. The first driver of this growth was investment. Fixed-asset investment grew by 25.8 percent annually for five consecutive years, substantially exceeding the growth rate of GDP (17.2 percent, based on current prices) over the same period. The percentage of investment rate (namely the rate of capital formation) in GDP rose from 35 percent to more than 40 percent. In face of the high growth, China failed to moderate quickly enough. China considered the pace of economic development to be "fast and healthy" because commodity prices remained low (CPI growth was lower than 4 percent). This pushed China's economy forward at a rapid clip, with growth hitting a record level of 14.2 percent[1] in 2007 before the outbreak of the international financial crisis.

Accompanying high domestic economic growth was a "blowout" in exports after 2002. For six consecutive years China's exports achieved annual growth of more than 20 percent; in 2003 and 2004, the growth rate even reached 35 percent. The general export trade in China, dominated by resource-intensive goods, achieved an average annual growth rate of more than 30 percent for five consecutive years, as a result of which, vast quantities of high-material-consumption, energy-intensive, and high-pollution goods were exported. Net exports in China rose from 2.2 percent in 2003 to 8.8 percent in 2007. This significantly increased foreign exchange reserves, which reached the US$ 1 trillion mark in 2006, making China the world's largest holder of foreign exchange reserves. The foreign exchange reserve increased to US$ 1.5 trillion in 2007, which became a controversial issue.[2]

In the previous shortage economy, high-speed economic growth and excessive investment growth usually led to a shortage of materials and inflation, and further resulted in a sharp increase in imports, a lower export growth rate, and tight supply of foreign exchange reserves, which ultimately cooled the economy. However, in the 21st century, what accompanies rapid economic growth is not just been increased imports but also rising exports, the latter even exceeding the former. Thus, both supply and demand have been strong, at the same time, there has only been a moderate increase in prices of commodities. This abnormal phenomenon concealed not only the overheating economy but also the universal excess capacity following

[1] Reference to the annual *China Statistical Yearbook.*

[2] Reference to the annual *China Statistical Yearbook.*

the system transformation.

Since accession to the WTO, China has begun to release excess capacity in the overseas market. From 2005 to 2007, 50 percent of China's end products were exported and the remaining half was for domestic consumption and investment[1]. This indicates that half of China's industrial production system was serving the world market.

2. Disadvantages of the current economic development pattern

The new conditions and changes appearing in the beginning of the 21st century have had a great impact on the key structures of the national economy.

2.1. Excessive economic growth leads to imbalanced aggregate demand structure and divergence from the goals of development

According to the estimation of the economics profession, the economic growth of developed countries depends mainly on total factor productivity, which is also known as the "Solow Residual." The "Solow Residual", first proposed by the American economist Robert Solow, refers to the excess portion of the growth rate of output compared with that of the input of factors such as labor, capital, and land. The sources of the Solow residual include technical improvement, organizational innovation, specialization, and production innovation. Total factor productivity makes up more than two-thirds of economic growth in developed countries, whereas it is lower than one-third in developing countries. As a developing country, China's economic growth does not rely on total factor productivity, but on the input of labor, capital, and land. China still enjoys an unconstrained supply of labor, which thus places no restraints on economic growth. China lacks original technologies and most total factor productivity is created by imported or generic equipment, namely by the input of capital. This determines that economic growth in China will rely on the input of production factors such as capital and land for some time to come.

Therefore, economic growth in China requires massive investment. However, domestic consumption will be unable to absorb the production capacity resulting from massive investment for sometime, and this capacity can only be released into the international market. This then leads to a falling consumption rate. Between 2000 and 2007, the ratio between consumption, investment and net exports decreased from 62.3:35.3:2.4 to 49.6:41:6:8.8. The consumption rate fell by 12.7 percentage points, while the investment rate and the rate of net exports increased by 6.3 and 6.4 percentage points, respectively, the latter two having nearly equal impact on the fall in the consumption rate[2]. In the first four years the impact came mainly from investment, and in the latter three years it came mainly from net exports. That is to say, the production capacity resulting from the massive investment in the first four years laid a foundation for later rapid

[1] Reference to the *China Statistical Yearbook* for 2005 and 2007, "Table of investment and output flows".

[2] *China Statistical Yearbook,* 2013.

growth in exports. In return, the tremendous growth in exports provided a basis for subsequent even larger-scale investment. In this way, investment has not been paired with consumption, but has increasingly relied on exports to absorb the "surplus" production capacity. This will ultimately lead to an internal imbalance (domestic savings greater than domestic investment, or supply greater than domestic demand) and external imbalance (disequilibrium of balance of payments and a sharp increase in foreign exchange reserves), which mutually reinforce each other.

2.2. Imbalanced aggregate demand structure hinders industrial restructuring and upgrading, leading to stagnation of development measures

Excessive economic growth and an imbalanced aggregate demand structure (high investment rate and overdependence on exports) will cause an imbalanced supply structure and hinder industrial restructuring and upgrading. This is because both investment and exports boost the secondary industry rather than the tertiary industry. In China, for every 100 yuan of investment in fixed assets, 92 yuan is used for the purchase of products of the secondary industry. Of 92 yuan, 32 yuan is used to purchase industrial equipment, while the remaining 60 yuan is mainly spent on high-energy-consumption and low-value-added construction materials, including rebar and cement. Only 6 yuan is used in the service industry[1]. Similar to investment, exports affect the secondary industry as well. Among all exported goods, over 80 percent are industrial goods, while services account for less than 20 percent. Thus, it can be seen that with investment dominated by "rebar and cement" plus the export of labor-intensive processing trade and the resource-intensive general trade, excessive growth will restrain the development of the tertiary industry.

The five years of 2003 to 2007 were the fast-growing period for investment in China. In those five years investment in fixed assets grew an average of 25.8 percent annually, pushing the average annual growth rate of GDP to 11.6 percent. Accordingly, the average annual growth rates of major investment goods were as follows: steel, 24.1 percent; glass, 18.1 percent; cement, 13.4 percent; raw coal, 11.7 percent; electricity generation, 14.7 percent; and energy consumption, 11.8 percent. All of these growth rates resulted in doubling within three to five years.

One can see that high growth driven by investment cannot be sustained. Moreover, the growth rate of exports in the same period reached an average of 30.2 percent (prices for the indicated years, US$). All this will lead to the rise of the proportion of the secondary industry and the fall of the proportion of the tertiary industry. The ultimate consequence will be difficulties for industrial upgrading. As a matter of fact, the development of China's tertiary industry does not lag at all. Between 2001 and 2007, the average annual growth rate of tertiary industry reached 11.8 percent. However, the secondary industry retained the same growth rate, thus the proportion

[1] Calculated according to the "Table of investment and output flows" for 2000, 2002, 2005 and 2007, from the *China Statistical Yearbooks*.

of the secondary industry rose from 45.2 percent to 47.3 percent, and net exports rose from 2.1 percent to 8.8 percent, causing the proportion of the tertiary industry to linger around 40 percent for several years[1].

Therefore, if China's investment and net exports maintain a high growth rate, not only will the consumption rate fall, but a mechanism will form that relies too heavily on low value-added manufacturing and restrains the development of high value-added manufacturing. As a result, China will fail at the mission of the five-year plan to improve the proportion of the tertiary industry and upgrade the industrial structure. In fact, the structural imbalance caused by sustained high-growth investment and exports, namely the imbalance in the industrial structure and demand structure, in return reinforces the rapid growth. That is to say, China's production structure was originally planned for investment and exports, and if investment and exports slump and lead to an economic downturn, there will be tremendous excess production capacity. This is because no matter how much stimulus is put into domestic consumption, there is no way for the domestic market to absorb millions of tons of steel, billions of tons of cement, and nearly 100 million construction workers. Such a structure presents a dilemma for macroeconomic regulation.

2.3. High investment and export rates have changed the income distribution structure and distorted the impetus for development

Although there is some rigidity in the income structure, in the context of rapid economic growth, the rapidly expanding economic "pie" provides the conditions for modifying such rigidity. First of all, strong investment, by affecting the production structure, will directly change the income distribution structure. The proportion of workers' wages to added value in the secondary is 46 percent, while that of the tertiary industry is lower at an average of 36 percent over a number of years. The industries driven by investment are largely heavy chemical industries as well as capital concentrated industries[2] like metallurgy and building materials, in which the proportion of labor remuneration to added value is lower. Given that high investment has driven the higher share of industry and construction and the rapid growth of heavy industry compared to light industry, it is inevitable that the share of labor remuneration will drop and the share of the enterprise income will increase accordingly.

Secondly, heavy investment has enhanced the status of capital in the distribution of factors. In the process of institutional change towards a market economy, if there is no special social policy through which capital can be obtained at a low cost, a "strong" position of unlimited labor supply will be formed. This will easily become a reality in periods of rapid economic growth. From 2000 to 2007, the share of labor remuneration fell rapidly. In addition to the agricultural industry, the proportion of labor remuneration in other industries to added value

[1] Reference to *China Statistical Yearbook*, 2013.

[2] For example, in 2008 fixed assets per capita in the raw materials industry was 350,000 yuan, but this figure for mechanical and electrical industry was only 163,000 yuan, less than half of the former.

fell: from 40 percent to 32 percent in industry; from 66 percent to 51 percent in construction; from 43 percent to 34 percent in the secondary industry. The share of worker compensation in the service industry in China also fell rapidly from 55 percent to 36 percent. In this way, the proportion of all worker compensation to gross domestic product decreased from 54 percent to 41 percent, a 13 percentage points drop in seven years.[1] It should be noted that this decline is quite rapid. At the same time, corporate income (retained earnings plus depreciation of fixed assets), representing capital factor income, rose rapidly from 31 percent to 44 percent, a 13 percentage points increase.

Due to the fact that exports are the primary driver of the secondary industry, the effect of exports on China's industrial structure and income distribution structure is similar to that of investment. Therefore, the rapid growth of exports will also cause an increase to the share if industry and a decline in that of the service industry, which will cement the status of capital in the distribution of factors, and then result in similar changes to the income distribution structure—the share of labor remuneration will drop while the share of enterprise income will rise.

We know that workers' remuneration accounts for most of household income (approximately about 83 to 85 percent), so the decreasing proportion of wages in GDP heralds a proportional income decline in GDP, which is an important reason for the declining consumption rate. On the other hand, the falling consumption rate is in fact reflecting the relative decline of residents' consumption ability from one perspective. Enterprises are market entities that make investments rather than consume, so the increasing share of enterprise income is not only the inevitable result of high investment and high exports, but also provides the funding source for high investment and high exports as well. It can be seen that such changes to the structure will aggregate the imbalances of the total demand structure: the consumption rate will continue to decline, while the investment rate and net export rate continue to rise. Although these changes directly affect the consumption, they do not affect the realization of products (exportable), which fully reflects the goal dissimilation of the economic development pattern focused primarily on investment and complemented by external resources.

So, in the first seven years of the 21st century, China not only failed to address the disadvantages of the existing economic growth pattern, but the problems even became more serious. This can be seen not only in the continued existence of extensive management, but also in excessive investment in terms of total demand, heavy reliance on external demand, and the declining consumption rate for successive years. Manifestations include excess aggregate supply capacity and difficulty in optimizing the industrial structure, the rapidly falling share of labor remuneration and rapidly rising proportion of enterprises in the income distribution structure, and continuously large increases to foreign exchange reserves. Coupled with phenomena such as excessive territorial development, continuous deterioration of the

[1] Calculated in accordance with the "input and output basic flow charts for 2000, 2002, 2005, 2002 (middle part)" which can be seen in *China Statistical Yearbook*.

ecological environment, and labor shortages due to the squandering[1] of the surplus rural labor force, there are many signs that such development can by no means be sustained. If we stick to the concept of the "transformation of the economic growth model" as a long-term task, it will be difficult to accurately summarize the new situation and new problems in the new period. There will also be a lack of focus, and China will not be able to solve the urgent problems in total demand, total supply and income distribution. So there is a need to coin a new and clear expression to depict and solve the problems in a fresh development stage. This was the main reason that the 17th CPC National Congress in 2007 included transformation of economic development pattern in its report.

3. Institutional reasons for the formation of China's economic development pattern

Since the mission of the transformation of economic development pattern was put forward in the report from the 17th CPC National Congress, the pace of the overall change over the past five years has been rather slow or even stagnant in some aspects, and the problems with the ecological environment have become more serious. One of the main indications is the further climbing of the investment rate.

Due to the impact of the international financial crisis in 2008, China employed a massive investment stimulus, enabling the investment rate to rise rapidly from 41.6 percent to 47.8 percent over the past five years. The consumption rate has remained almost unchanged, while net exports have declined annually. These are both byproducts of the crisis rather than the result of China's adjustments.

The other indication is the further extension of industries with low added value. The development pattern relying on "steel and cement" has gained momentum in response to the crisis, with the output of steel and concrete maintaining annual growth of 14 percent on average for three consecutive years from 2009 to 2011, far more than the 9.7 percent GDP growth rate. In 2012, when GDP growth rate dropped to a relatively normal level of 7.7 percent, overcapacity became very prominent in some main industries. Consequently, the secondary industry continued to be the main portion in overall supply (the contribution rate of the secondary industry exceeded that of the tertiary industry by nearly 10 percentage points).

The main reason lies in the relatively fast economic growth over the past five years. An average of 9.6 percent annual growth rate in the first four years means investment has had to play a leading role in driving the troika of aggregate demand (the contribution rate of investment exceeded that of consumption by nearly 10 percentage points). This in return resulted in the secondary industry playing the primary role as aggregate supplier(the contribution rate of the secondary industry was higher than that of the tertiary industry by nearly 10 percentage points). Third, although the proportion of labor remuneration has

[1] Some enterprises recruit only laborers under 35, while some dismiss laborers who are just over 35 or 40 and replace them with younger ones in twenties. Some rural workers who have lost labor capacity due to contracting occupational diseases after working for several years are also fired.

improved, the increase is not fully comparable due to the 2008 economic census and other statistical factors (See Table 1).

Table 1
Changes to main economic structures from 2007 to 2012(%)

Year	Aggregate Demand Structure			Industrial Structure			Essential Factors Structure		
	Consumption Rate	Investment Rate	Net Export Rate	Primary Industry	Secondary Industry	Tertiary Industry	Worker Compensation	Corporate Income	Net Product Tax
2000	62.3	35.3	2.4	15.1	45.9	39.0	48.7	36.0	15.3
2007	49.6	41.6	8.8	10.8	47.3	41.9	39.7	45.5	14.8
2008	48.6	43.8	7.7	10.7	47.4	41.8	—	—	–
2009	48.5	47.2	4.3	10.3	46.2	43.4	46.6	38.2	15.2
2010	48.2	48.1	3.7	10.1	46.7	43.2	45.0	39.7	15.2
2011	49.1	48.3	2.6	10.0	46.6	43.4	44.9	39.5	15.6
2012	49.5	47.8	2.7	10.1	45.3	44.6	45.6	38.5	15.9
	Average contribution rate			Average contribute rate					
08-11	48.4	58.8	-7.2	4.7	52.4	42.9			

Note: Corporate income includes operating surplus and depreciation of fixed assets; There are no figures for factors distribution in 2008.

Source: *China Statistical Yearbook 2013*.

Thus, as long as the mechanisms and systems responsible for the excessively rapid economic growth do not change, it is difficult to realize change to the economic development pattern. Therefore, it is necessary to explore the causes at the level of the mechanism of the current economic development pattern.

3.1. Local governments transformed from profit entities into market entities

In 1978, the Third Plenary Session of the Eleventh CPC Central Committee denied the basic guiding principle of class struggle that the country had adhered to for two decades, and a national policy of focusing on economic development was determined. The shift of focus was proved to be solute, timely, and correct decision, thus earning nationwide advocacy. Given that government administration and enterprise management were unified and the economy owned by all the people was in a dominant position, developing the economy entailed vitalizing enterprises. This in turn required transferring power to local governments at all levels, because at that time nearly all enterprises were affiliated with local governments.

The fiscal system of "dividing revenue and expenditure between the central and local governments" mobilized the enthusiasm of local governments and turned them into formidable profit entities, which truly implemented the policy of "focusing on economic development," pushing all of society to boost economic construction and make eye-catching achievements.

To focus on economic development is in essence to gather all administrative resources in an attempt to realize leapfrog and unconventional development. The problem was that in 1992, China began steering toward the market economy, and the whole economic system began to transform gradually into a market system. By 2000, the basic market economy structure had been formed. But local governments focused on economic development accordingly transformed themselves from profit entities into market entities. Tens of thousands of government entities(31 provincial-level cities and 300 prefecture-level cities as well as nearly 3000 counties and 40000 towns and villages, and perhaps smaller units) which undertook the task of building a moderately well-off society in an all-round way fully employed the market to allocate resources directly according to their own development goals. However, in so doing, it is difficult to realize allocation of resources in accordance with market rules.

3.2. Governments have become an inherent paradox as market entities

3.2.1. The individual rationalities of local governments do not imply the collective rationality of the whole nation

Every five years, governments at and above the county level compile plans for economic and social development. People's Congresses of the same level then review these plans, which are implemented by government departments. Few of these plans could be accused of breaking from reality or deviating from the demands of the central government.

The question is how government at each level organizes and implements these plans. One way is for the government's plan only to aim to ensure the production and operation of enterprises and project investment is consistent with the plan in a guiding manner rather than being in charge of its implementation. The other is that the government is responsible for both the formulation and implementation of plans, which is our principal choice currently.

Although plans are sometimes "hung on the wall but not put into practice," the government policy of focusing on economic development has indeed been carried out, and it is therefore reasonable to adapt plans to changing circumstances. It should be noted that when tens of thousands of such "rational" entities gather together, collective irrationality is always the result. Either the plan formulated by higher authorities is toppled by lower authorities or the latter is eliminated by the former. Such can be compared to the concepts of "finite" and "infinite" in math, for which the correct conclusion obtained in a "finite" context is always uncertain or even incorrect when placed in "infinity." For example, all regions are currently requiring the goal of building a well-off society. Understandably, there is nothing to be said against this notion since it is better to get rich sooner, and everyone desires to seize the "strategic opportunity." Inland areas hope to catch up with the coastal areas, while the coastal areas aim to pursue "Four Asian Tigers" through an "unconventional manner." A 10 percent growth rate seems to be the bottom line for most regions, while 15 percent or 20 percent are normal goals.

Yet, if the development of all the regions becomes faster, the total economic growth rate of the whole nation is bound to exceed an acceptable level. The resources China possesses can maintain the annual growth rate of dozens of prefecture-level cities or hundreds of counties at 15 percent or 20 percent, but cannot do so for 300 prefecture-level cities and 3,000 counties at the same time. For another example, a certain industry may be competent enough as a pillar industry or strategic emerging industry from a national perspective, but there is significant flexibility and uncertainty as to whether to bring that industry online in any given area. Therefore, it is understandable that each region passionately supports national industrial policy and even strives to create opportunities when there are none. There is no point in denying such beliefs—the behavior may even be worth encouraging. However, so many localities swarming into an industry usually results in national overcapacity. Such overheating and excesses occur again and again in China, and only "macroeconomic regulation" can handle the situation. What is left is a large amount of abandoned projects and huge sums of bad or doubtful debt.

Then, is it possible to shift into another organizational manner in which departments related to planning at all levels communicate and coordinate with each other more frequently in order to perfect "collective rationality"? Such an assumption would require the subordinate authority submit its plan to its higher authority for approval, which in turn would become a typical planned economy requiring the government to allocate resources in a top-down manner and in an all-around way. For example, on a national basis, if 8 percent growth rate is reasonable and is to be carried out in each region, both a constant growth and a varied growth can only be distributed by orders in a manner of a designated growth rate, or rather credit orders from banks. Otherwise, it would be impossible to ensure a reasonable growth rate for a whole nation.

3.2.2. It is difficult for governments to undertake market responsibility as market entities

In a market economy, "investing is risky, and entering the market requires caution." It is enterprise or individual themselves that must ultimately be responsible for their actions, be it by "getting rich" or by "going bankrupt" overnight.

We have seen that in a market economy country, the failure rate for the enterprises in the first year of opening is as high as 60 to 80 percent, and this figure remains around 20 percent even after five years. It is the mass starting up and dying out of large numbers of small businesses that become the main melody in the structural adjustment and upgrading of a market economy, constituting the beautiful and tragic scenery of vibrant economic life.

But when the government serves as the market subject, its error rate of investment is not certain to be higher than that of enterprises or individuals. The problem is how to pay for the losses resulting from these mistakes. Mistakes made by the government at a lower level can only be borne by the government at a higher level, and national mistakes can only be solved by inflation or increased taxes, which are eventually paid off by taxpayers. Because the

government is, after all, legal entity of public law that nearly never goes bankrupt, we can give it the authority of being a market entity, but cannot let government undertake the responsibility of a market entity. So the investment behavior of government in a market economy is firmly constrained and can only play a limited role in dealing with market failures, such as necessary infrastructure construction. If the people's governments at all levels in China are shouldered with the mission of leading the people in their jurisdiction to strive for a well-off life, burdened with the task of "managing cities and promoting investment," and charged with organizing and implementing the development plan directly, the government would actually take on unlimited liability and would not be constrained. This is obviously opposite to China's goal of the reform of market economy.

3.2.3. The government will be tied up in overstepping its authority, being absent, and misplacing its authority

The report from the 16th National Congress of the Communist Party of China in 2002 clearly put forward that the function of the government is "economic regulation, market supervision, social management, and public service." But in the past decade, the implementation of these functions has not been satisfactory, while the function of economic construction has expanded quickly. This was reflected incisively and vividly in the recent international financial crisis.

The functions of local governments are partly economic construction and partly public service. There are key differences between the two: the former is factual while the latter is virtual; the former is primary, while the later is complementary; the former is mighty, while the later is vulnerable. This leads to a phenomenon that in some places the focus of economic development has already evolved to a focus on managing cities, promoting investment, land finance, or demolition. Such a role for government is far from the image of a competent referee that people expect and bears no relationship with the functions that the central government has ascertained. With market reforms, local governments turn naturally and unrestrainedly into market entities, and shift responsibility for the allocation of resources from plans to the market. Though very effective for promoting economic growth, it is also an excuse to evade responsibility for the provision of basic public services. It is increasingly difficult to guarantee the quality of economic growth due to the great waste and loss caused by projects meant only to look good on official performance evaluations, image projects, and jerry-built projects, and serious damage has been done to the government's image and credit. More seriously, this "turn" directly interferes and even undermines the fundamental market order. Because when local governments become real market entities like companies or quasi-corporations, they configure resources more directly. Just like in a monopoly, regional blockades for regional protection can easily occur. In this way, there is little reason to follow the market rules of fair competition and survival of the fittest. At the same time, opportunities are provided for abuse of public power, alienation, rent-seeking, and corruption. This would cause irreversible economic and social disorder.

3.3. The government as a market entity is the systematic basis of the current economic development pattern

The fiscal system that divides revenue and expenditure between the central and local governments and promotes more expenditure on the basis of more revenue that governments at all levels adhere to is in essence much the same as "production contracted to each household" in the countryside and "enterprise contracting" in cities. It is just the extension of economic means to arouse the enthusiasm of each party. The only difference is that this extends to the inside of government. The administrative relationship among governments at different levels is turned into a business relationship, departmental relationships are turned into market relationships, and public management is turned into business management.

This enables China's local governments to become market entities with administrative power whose behavior generally conforms to the Economic Person Assumption, and their profit-seeking feature of "benefit maximization" endows them with extraordinary economic initiative.

The series of problems resulting from the above are almost non-existent in developed countries and rare in other BRIC countries or emerging countries. For example, macroeconomic regulation and control turns out to be the regulation of the local governments by the central government, rather than government regulation of the market. Unexpectedly, it is some government sectors that delay wages for migrant rural workers and neglects the social public trust (because our officials often adhere to the rule that "new officers ignore the old debts of the former officials," that is, the successor is not responsible to pay off the debts borrowed by his predecessor). China's development is clearly characterized by seeking instant success and benefits, enjoying benefits coming at an earlier time, getting golden eggs by killing the goose that laid them, and getting fish by draining the pond. It has been a commonplace that the predecessor builds while his successor demolishes or the former digs while the latter fills.

Facts in the past five years have shown that these problems have not been restrained. Instead, there are signs that they are becoming increasingly prominent. For example, to cope with the international financial crisis, the number of local government financing platforms rose sharply. Another example is that the economic "slide" in 2013 prompted the main functional departments of some local governments to set up their own enterprises in case of an "austere environment."[1] In face of the strong and impulsive desire of local government to develop the economy, other problems have been ignored or put aside. In face of such high-profile intervention in the market and acting as market entities as well as the practices of local

[1] According to the coverage of 'China Comment' of October 16th, 2013, currently government authorities of Wuhan city have established enterprises solely-invested by themselves or under their control, such as the Water Conservancy Investment Group Co. under the water department, the Transportation Investment Co. under the transportation department, the Agricultural Investment Co. under the agricultural department, the Tourism Investment Co. under the tourism department, the Technology Investment Co. under the technology department, the Environment Investment Co. under the environmental protection administration, and even the Environmental Sanitary Investment Co. under the urban management bureau.

governments equating themselves with or even outmatching enterprises, people have been put in a deep quandary: is this what we should expect from the market economy? Are there market rules and discipline to follow? Is our knowledge of government as a "competent referee" too shallow and pedantic or have our behaviors disobeyed the basic principles of the market economy consciously or unconsciously?

Therefore, however strong, correct and beautiful our desire for scientific development is, without resolute measures, these problems will no doubt continue through the end of the Twelfth Five-year Plan or even the end of the Thirteenth Five-year Plan. What we worry about is not the existence of these problems, but that they continue to worsen and show no sign of being curbed. Once they break out intensively, China will quite likely fall into the "middle-income trap" of South America, or into the "resource exhaustion trap" that occurred in the planned economy of the former Soviet Union, both of which would have a bearing on whether the "goal of building a well-off society in an all-around way and realizing China's rejuvenation" can be achieved by the one-hundred-year anniversary of the founding of CPC and PRC.

Thus, the systemic foundation deciding the current economic development pattern is mainly governments at all levels that act as market entities but fail to bear the corresponding responsibilities, which is a natural result of the fiscal policy of thirty years ago to divide revenue and expenditure between central and local governments and focus on economic development, as well as the unchanged government function in turning the whole economic system into a market economy twenty years ago.

In terms of China itself, this economic development pattern is neither likely to have appeared in the 20th century, nor to continue into 2020, due to its periodical characteristics. But on a global scale, there are many countries that are in the same stage of development as China. Yet it is hard to find a similar economic development pattern, which shows there is no connection between these problems and the development stage. Thus, we can understand the reason we have diverged so far from our development goals. We still actively continue to push up investment even when our investment rate has been close to 50 percent and number one in the world, and we do not mind the falling residential consumption rate to 35 percent as the worldwide lowest. Thus we understand why there is such obvious stagnation in our development means, why the proportion of the second industry hovers at such a high level, and why we continue to expand capacity even when steel production capacity exceeds 1 billion tons and cement production capacity exceeds 3 billion tons. As long as growth increases, the capacity will be released immediately and even be in short supply. Thus we understand why we still feel at ease and remain unruffled even if our motivation for development has been distortedly so obviously, laborer remuneration is falling constantly, and the proportion of capital payments are increasing. This is due not only to the never-ending development speed and local governments competing to defend their territory, which is of course legal, and also invulnerable politically and morally, since the justness of realizing the goal of building a well-off society earlier is indisputable.

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