Private ownership:
The real source of China’s economic miracle

Even many Western economists think China has discovered its own road to prosperity, dependent largely on state financing and control. They are quite wrong.

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The credibility of American-style capitalism was among the earliest victims of the global financial crisis. With Lehman Brothers barely in its grave, pundits the world over rushed to perform the last rites for US economic ideals, including limited government, minimal regulation, and the free-market allocation of credit. In contemplating alternatives to the fallen American model, some looked to China, where markets are tightly regulated and financial institutions controlled by the state. In the aftermath of Wall Street’s meltdown, fretted Francis Fukuyama in Newsweek, China’s brand of state-led capitalism is “looking more and more attractive.” Washington Post columnist David Ignatius hailed the global advent of a Confucian-inspired “new interventionism”; invoking Richard Nixon’s backhanded tribute to John Maynard Keynes, Ignatius declared, “We are all Chinese now.”

But before proclaiming the dawn of a new Chinese Century, leaders and executives around the world would do well to reconsider the origins of China’s dynamism. The received wisdom on the country’s economic miracle—it was a triumph of technocracy, in which the Communist Party engineered a gradual transition to the market by relying on state-controlled businesses—gets all the important details wrong. This standard account holds that entrepreneurship, private-property rights, financial
liberalization, and political reform played only a small role. Yet my research, based on a detailed analysis of the Chinese government’s survey data and government documents at the central and local levels, indicates that property rights and private entrepreneurship provided the dominant stimulus for high growth and lower levels of poverty.

We often read that gradualism was the key to China’s successful transition from Marx to the market; many accounts laud Beijing for eschewing Russian-style shock therapy in favor of a more pragmatic approach that created a hospitable business environment and allowed private companies to grow organically. This narrative suggests China’s economy grew progressively more liberal and market-oriented through reforms that were introduced on a small scale in the 1980s and gathered momentum in the later half of the ’90s. Not so. What actually happened is that early local experiments with financial liberalization and private ownership, in the 1980s, generated an initial burst of rural entrepreneurialism. Those earlier gains—not the massive state-led infrastructure investments and urbanization drive of the 1990s—laid the true foundation for the Chinese miracle.

Although many experts contrast China’s grand infrastructure projects and gleaming factories built using foreign money with India’s dilapidated highways and paltry foreign-direct-investment flows, this point of view overstates the contribution of public spending and foreign investment to China’s growth. Neither of these forces assumed huge proportions in China until the late 1990s—long after relaxed financial controls and rural entrepreneurship prompted the initial growth surge, during the 1980s.

In that decade, China’s economy grew more rapidly than it did in the 1990s and brought better social outcomes: poverty declined, the gap between rich and poor narrowed, and labor’s share of GDP—a measure of the way average people benefit from economic growth—rose substantially. From 1978 to 1988, the number of rural people living below China’s poverty line fell by more than 150 million. In the 1990s, their number fell by only 60 million, despite almost double-digit increases in GDP growth and massive infrastructural construction. What’s more, in the 1980s China’s growth was driven far less than it is today by investments as opposed to consumption. In other words, entrepreneurial capitalism, unlike state-led capitalism, not only generated growth but also dispersed its benefits widely. Entrepreneurialism was virtuous as well as vibrant.

Big cities like Beijing, Shanghai, and Shenzhen are routinely extolled in the Western press as vibrant growth centers (exhibit). China’s rural areas, if mentioned at all, typically figure as impoverished backwaters. But
a close analysis of the economic data reveals that these breathless descriptions of China’s modern city skylines have it exactly backward: in fact, the economy was most dynamic in rural China, while heavy-handed government intervention has stifled entrepreneurialism and ownership in the urban centers.

The significance of this last point is impossible to overstate. Indeed, much of the history of Chinese capitalism can be characterized as a struggle between two Chinas: the entrepreneurial, market-driven countryside versus the state-led cities. Whenever and wherever rural China has the upper hand, Chinese capitalism is entrepreneurial, politically independent, and vibrantly competitive. Whenever and wherever urban China dominates, Chinese capitalism tends toward political dependency and state centricity.

Shanghai is the most visible symbol of China’s urban development. Its modern skyscrapers, foreign luxury boutiques, and top-ranking GDP per
capita make it China’s model city—a glittering testament to the success of state-led capitalism. Or is it? By more meaningful measures of economic achievement, Shanghai’s rise is far less impressive than that of Wenzhou, an enclave of entrepreneurial capitalism a few hundred miles to the south, in Zhejiang province. In the early 1980s, Wenzhou was known for little more than its struggling farmers. Of five million inhabitants, fewer than 10 percent were classified as urban. Today, Wenzhou is China’s most dynamic municipality, teeming with businesses that dominate European garment markets. By contrast, Shanghai, once home to China’s earliest industrialists, is now oddly bereft of native entrepreneurs.

Wenzhou’s transformation resulted almost entirely from free-market policies. As early as 1982, officials there were experimenting with private lending, liberalized interest rates, cross-regional competition by savings and loans organizations, and lending to private-sector companies. The Wenzhou government also worked to protect the property rights of private entrepreneurs and to make the municipality friendly to business in many other ways.

Does indigenous entrepreneurship make a difference for human welfare? Abundantly. In GDP per capita, Shanghai is almost twice as rich as Zhejiang, where Wenzhou is located (detailed data on Wenzhou are harder to get). But if the measure is household income—the actual spending power of average residents—the two regions are equally prosperous. In 2006, a typical Shanghai resident earned a household income 13 percent higher than that of a typical Zhejiang resident, but in Shanghai the level of unearned income (for example, government benefits) was almost twice as high as in Zhejiang. Earned income was about the same for average residents of the two places. On average, Shanghai residents earned 44 percent less than their counterparts in Zhejiang from operating businesses and 34 percent less from owning assets. The implication: state-led capitalism may lift urban skylines and GDP statistics but not actual living standards.

The contrast is clearer still if you examine the economic profiles of Zhejiang province and its northern neighbor Jiangsu province. The two make for a near-perfect comparison. Their geographic conditions are almost identical: both are coastal, with Jiangsu to the north of Shanghai and Zhejiang to the south. They also have similar business histories: both contributed significantly to the ranks of industrialists and entrepreneurs in prerevolutionary Shanghai. During the postreform years, however, Jiangsu courted foreign investment and benefitted significantly from public-works spending; Zhejiang did not. The results of that difference are startling.
Jiangsu was richer than Zhejiang 20 years ago, but today it is poorer, lagging behind in every significant measure of economic and social welfare. On average, Zhejiang’s residents earn significantly more from assets than their northern neighbors do, live in larger houses, and are far more likely to own phones, computers, color televisions, cameras, or cars. They also enjoy lower rates of infant mortality, a longer life expectancy, and higher literacy. Notably, income inequality is far lower in Zhejiang than in Jiangsu. How to account for Zhejiang’s greater prosperity? The most compelling explanation is that in Jiangsu, the authorities meddled in the economy and discriminated against local businesses in favor of foreign capital. Officials in Zhejiang granted free rein to indigenous entrepreneurs, allowing them to build larger, more dynamic local supply chains.

The real mystery of China’s miracle isn’t how the economy grew, but how Western experts got the growth story so wrong. One answer is that outsiders misunderstood the nature of one of China’s most basic economic institutions: township and village enterprises, which some of the West’s best-known economists have celebrated as the epitome of capitalism with Chinese characteristics—innovative hybrid entities that achieved high growth despite government control. Nobel laureate Joseph Stiglitz, for example, extolled them for offering an ingenious solution to a problem common to economies in transition from socialism to capitalism: asset-stripping by private investors.¹ These enterprises, he argues, are a form of public ownership that prevents plundering while achieving the efficiency of private-sector companies.

In short, Western economists have often assumed township and village governments own these enterprises. As recently as 2005, Douglass North, another Nobel winner, stated in the Wall Street Journal that they “hardly resembled the standard firm of economics.”² But the evidence suggests otherwise. A policy document issued by the State Council on March 1, 1984, includes the first official Chinese reference to township and village enterprises. It defined them as “enterprises sponsored by townships and villages, the alliance enterprises formed by peasants, other alliance enterprises, and individual enterprises.” The term “enterprises sponsored by townships and villages” referred to the collective undertakings townships and villages

own and run. All the other entities mentioned in the policy document were private businesses: single proprietorships or larger private companies with a number of shareholders—precisely “the standard firm of economics.” Official usage of the term “township and village enterprise” has been remarkably consistent: it always includes private businesses as well as those sponsored by governments.

Western economists erred because they assumed the term referred to ownership. But Chinese officials understood it in the geographic sense—businesses located in townships and villages. The records of China’s Ministry of Agriculture attest that privately owned and run entities dominated the total pool of these enterprises. During the years from 1985 to 2002, the number of collectively owned ones peaked in 1986 at 1.73 million entities, while the number of private ones soared to more than 20 million, from about 10.5 million. In other words, the increase in the number of these enterprises during the reform era was due entirely to the private sector. By 1990, within the first decade of reform, such private businesses accounted for 50 percent of total employment in town and village enterprises and claimed 58 percent of their after-tax profits.

Confusion about the real origins of Chinese growth has clouded foreign perceptions of the emergence of Chinese companies in the international marketplace as well. It is often said China heralds a new business model for global competition, in which state ownership and the judicious use of government financial controls combine to create a unique source of competitiveness. The computer maker Lenovo is often touted as a product of China’s unconventional business environment.

But Lenovo owes much of its success to its ability, early on, to establish legal domicile and raise capital in Hong Kong, arguably the world’s most free-wheeling market economy. Lenovo got its initial financing from the Chinese Academy of Sciences, in 1984, but thereafter secured all of its significant investment from Hong Kong. In 1988, the company received HK $900,000 (US $116,000) from the Hong Kong–based company China Technology to invest in a joint venture that would enable Lenovo to claim the city as its legal domicile. In 1993, Hong Kong Lenovo went public on the Hong

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Kong Stock Exchange in a US $12 million IPO. Lenovo is a success story of Hong Kong’s market-based financial and legal system, not of China’s state-controlled financial system.

As China absorbs the lessons of the Wall Street debacle and prepares itself for a global economic slowdown, the worst thing the country could do would be to embrace the notion that it has discovered a new development formula more effective than free markets. The real lesson of China’s economic miracle is that it was actually remarkably conventional—based on private ownership and free-market finance. China’s experience offers the world a timely reminder that reforms designed to encourage these forces really work.

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