

## THE CHINESE ECONOMIC SYSTEM IN THE LAST 20 YEARS. AN ECONOMIC FREEDOM INDEX-BASED ANALYSIS

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### Abstract

*For much of human history, most individuals have lacked economic freedom and opportunity, condemning them to poverty and deprivation.*

*Today, we live in the most prosperous time in human history. Poverty, sicknesses, and ignorance are receding throughout the world, due in large part to the advance of economic freedom. In 2015, the principles of economic freedom that have fueled this monumental progress are once again measured in the Index of Economic Freedom. In order to have an overall view on the evolution of the Chinese economic system, we have analysed the 10 components of the economic freedom index: financial freedom, investment freedom, commercial freedom, monetary freedom, freedom to make business, governmental expenses, ownership rights, tax freedom, labour market freedom, the corruption level.*

**Key words:** *China, reforms, economical system, Index of Economic Freedom*

**JEL Classification:** *P21, P16, P31*

### I. THE OPENNESS OF MARKETS

#### Commercial freedom

Commercial freedom is a combined index of the absence of fee and non-fee-based barriers affecting imports and exports of goods and services. The commercial freedom score is based on two input data:

- The average commercial weighted fee
- Non-fee-based barriers (NFB).

The various imports coming into a country may be and are frequently facing various fee-based barriers. The average weighted fee uses shares for each fee, based on the import quotas for each category of goods. Average weighted fees are a purely quantitative measure and result in the basic calculation of the score, based on the following formula:

$$\text{Economic freedom}_i = (((\text{Fee}_{\max} - \text{Fee}_i) / (\text{Fee}_{\max} - \text{Fee}_{\min})) * 100) - \text{NFB}_i$$

where  $\text{Economic freedom}_i$  is economic freedom in the  $i$  country,  $\text{Fee}_{\max}$  and  $\text{Fee}_{\min}$  are the upper and lower limits of fees (%), and  $\text{Fee}_i$  represents the average weighted fee (%) in country  $i$ . The minimum fee is, obviously, 0%, while the upper limit was set at 50%. A penalty for NFB is then subtracted from the basic score. This has a value of 5, 10, 15 or 20 points and is allocated as follows:

20 - NFB are used extensively, for many products and services and/or operate to efficiently restrict a significant part of international trade

15 - NFB are used on a wide scale for many products and services and/or operate to efficiently restrict most of the potential international trade

10 - NFB are used to protect certain products and services and to restrict a part of international trade

5 - NFB are an exception, as they only protect some product and services and/or have a very limited impact on international trade

0 - NFB are not used to limit international trade.

The scope of NFB in the commercial policy of a country is determined by means of quality and quantity-related information. The restrictive rules obstructing commerce vary widely, and their changing character makes their complexity hard to calibrate. The categories of NFB considered in our penalty include:

- Quantity-based restrictions - import quotas, export limitations, voluntary export restrictions, embargoes and import-export interdictions, barter, etc.

- Price restrictions - anti-dumping fees, compensatory fees, adjustments of customs taxes, imposition quotas/variable fees

- Restrictions due to regulations - licenses, requirements regarding the content/mix of internally produced goods, sanitary and phyto-sanitary standards, regulations on industrial and security standards, regulations on

packaging, labelling and commercial brands, regulations on advertisement and the publication of ads in various media

- Restrictions on investments - controls on the exchange rate and other financial controls
- Customs restrictions - requirements regarding advance payments, customs assessment procedures, customs classification procedures, customs release procedures
- Direct government intervention - subsidies and other aids, measures on industrial policy and regional development, government-funded research and other technology-related policies, national fees and social insurance, policies on competition, immigration and governmental purchases, state commerce, governmental monopolies and exclusive franchises (<http://www.heritage.org/index/open-markets>).

Commercial freedom in China had a strong ascending trend during 1995-2006, from 20 to 68 points, as a result of the reforms taken for the accession to the WTO (2001) and subsequently due to legal adaptations to the requirements of the Organisation (after accession, China had 5 years of grace to adjust its legal framework according to its membership; this is referred to in scientific literature as the 2001-2006 "honey moon"). After this period, the rate of reforms in international trade decreased dramatically, which resulted in a slight increase of the commercial freedom index during 2007-2015, from 68 to 71.8 in the present times.

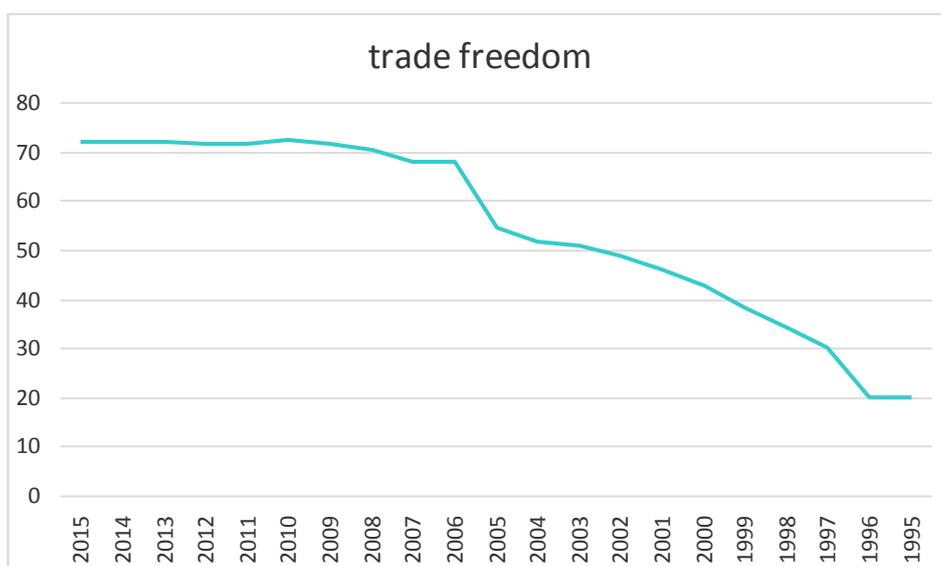


Figure 1 - Trade freedom

### Financial freedom

Financial freedom is a measure of the efficiency of the banking system, and of its independence from governmental control and other interferences in the financial sector. The state's possession of banks and other financial institutions, such as insurers and capital markets, reduces competition and generally lowers the level of available services.

In an ideal banking and financial environment, where government interferes to a minimum extent, the supervision and regulation of financial institutions by an independent central bank are limited to the imposition of contractual obligations and fraud prevention. Loans are granted as per the market requirements, and the government holds no financial institutions; they provide very diverse types of financial services to natural persons and legal entities. Banks are free to provide loans, to accept deposits and perform foreign currency operations. Foreign financial institutions operate freely and are treated just like domestic ones.

The index outlines the financial freedom of an economy, considering the following five areas:

- The scope of the governmental regulation of financial services
- The level of state intervention in banks and other financial institutions through direct and indirect ownership
- The development of financial and capital markets
- The government's influence on the award of loans
- Openness towards foreign competition.

These five fields are to be taken into account with a view to assessing the overall financial freedom of an economy, ensuring easy and efficient access to funding opportunities for both the natural persons and legal entities in the concerned economy. An overall score ranging from 0 to 100 is awarded to financial freedom, by reducing the ideal score of 100 points.

100 - Negligible governmental interference

90 - Minimum governmental interference. The regulation of financial institutions is minimal, but it may extend beyond the imposition of contractual obligations and fraud prevention.

80 - Non-significant governmental interference. Governmental ownership in financial institutions is only a small part of total ownership. Financial institutions have almost no restrictions regarding their services.

70 - Limited governmental interference. The award of loans is influenced by the government, but the award of the private loans basically has no restrictions. Governmental ownership in financial institutions is significant. Foreign financial institutions have few restrictions.

60 - Significant governmental interference. The central bank is not completely independent, its supervision and regulation of financial institutions is somewhat burdening, and its ability to impose the observance of contractual clauses and to prevent fraud is insufficient. The government exercises the ownership and active control of financial institutions, with a significant quota in the total goods of the system. The ability of financial institutions to provide financial services is subject to certain restrictions.

50 - Considerable governmental interference. The award of loans is significantly influenced by the government, and the award of the private loans faces significant barriers. The ability of financial institutions to provide financial services is subject to major restrictions. Foreign financial institutions have some restrictions.

40 - Strong governmental interference. The central bank is subject to government influence, its supervision of financial institutions is burdening, and its ability to impose the observance of contractual clauses and to prevent fraud is low. The government exercises the ownership and active control of financial institutions, with a large minority quota in the total goods of the system.

30 - Extended governmental interference. The award of loans is extensively influenced by the government. The government holds or controls most financial institutions or holds a dominant position. They are strongly restricted, and the establishment of a bank faces significant barriers. Foreign financial institutions have significant restrictions.

20 - Burdening governmental interference. The central bank is not independent, and its supervision of financial institutions is repressive. Foreign financial institutions are discouraged or subject to major constraints.

10 - An almost repressive system. The award of loans is controlled by the government. The establishment of banks is restricted. Foreign financial institutions are forbidden.

0 - Repressive system. Supervision and regulation aim at preventing the development of private financial institutions, which are forbidden.

The financial freedom of the Chinese economic system was constant during 1995-2000, reaching a maximum level of 50 points, i.e. the system had the following features during that period: Considerable governmental interference. The award of loans is significantly influenced by the government, and the award of the private loans faces significant barriers. The ability of financial institutions to provide financial services is subject to major restrictions. Foreign financial institutions have some restrictions.

A sudden decrease in financial freedom followed during 2000-2001, up to 30 percent (which is also the current level); the system had the following features during that period: Extended governmental interference. The award of loans is extensively influenced by the government. The government holds or controls most financial institutions or holds a dominant position. They are strongly restricted, and the establishment of a bank faces significant barriers. Foreign financial institutions have significant restrictions.

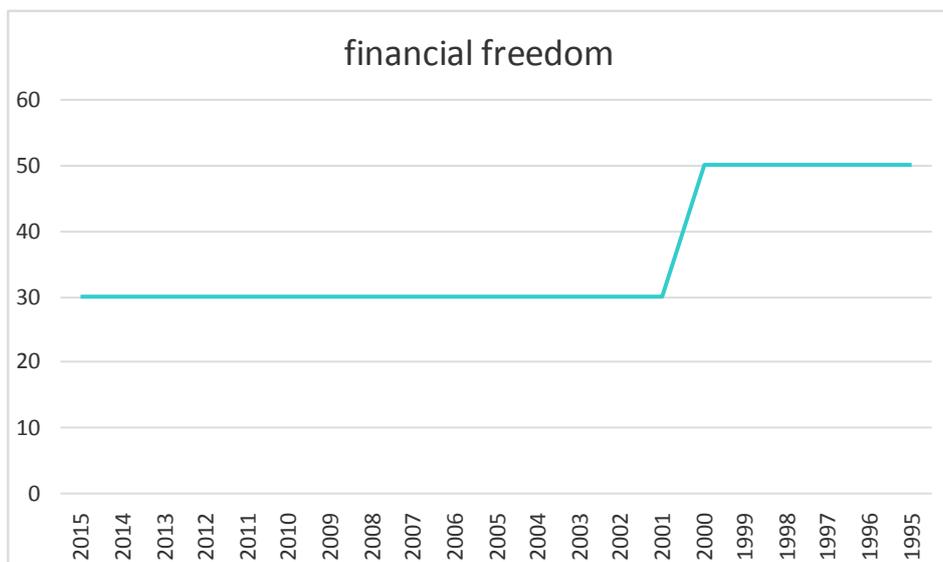


Figure 2 - Financial freedom

**Investment freedom**

A country that is free from an economic point of view, there are no restrictions on invested capital. Natural persons and legal entities may transfer their resources to and from any activity, both within and outside borders, with no restrictions. Such a country (an ideal one) will receive a score of 100 points in the investment freedom component of the Economic Freedom Index.

In practice, most countries have a variety of restrictions regarding investments. Some have different rules for domestic investment compared to the foreign ones; others restrict access to foreign currency exchange or impose restrictions on payments, transfers and capital transactions. Finally, some countries forbid the access of foreign investments in some areas. Regulations regarding labour, corruption, bureaucracy, poor infrastructure, political and security conditions may also affect the investors' freedom on a market.

The index assesses a wide range of restrictions usually imposed on investments. Points are subtracted from the ideal score of 100 for each of these (according to the details below). A government needn't impose all the listed restrictions to a maximum extent in order to actually remove investment freedom. The few governments which impose so many restrictions that their score becomes negative have been awarded zero points.

Investment restrictions:

Assimilation of foreign investments to domestic ones

- No assimilation, just pre-qualification 25 points less
- Partial assimilation and pre-qualification 15 points less
- Partial assimilation or pre-qualification 5 points less

Legislation associated to foreign investments

- Lack of transparency and burdened by bureaucracy 20 points less
- Inefficient implementation and strong bureaucracy 10 points less
- Some laws on investments and related practices are not transparent or not efficiently implemented 5 points less

Restrictions on land ownership

- All real estate purchases are restricted 15 points less
- Foreign citizens cannot purchase real estate 10 points less
- Some restrictions on real estate purchases 5 points less

Sectoral restrictions on investments

- Restrictions on many sectors 20 points less
- Restrictions on some sectors 10 points less
- Restrictions on 1-2 sectors only 5 points less

Expropriation of investments with no suitable compensation

- Usual, with no possibility of appeal in court 25 points less
- Usual, but with possibility of appeal in court 15 points less
- Not usual, but sometimes happens 5 points less

Foreign currency exchange controls

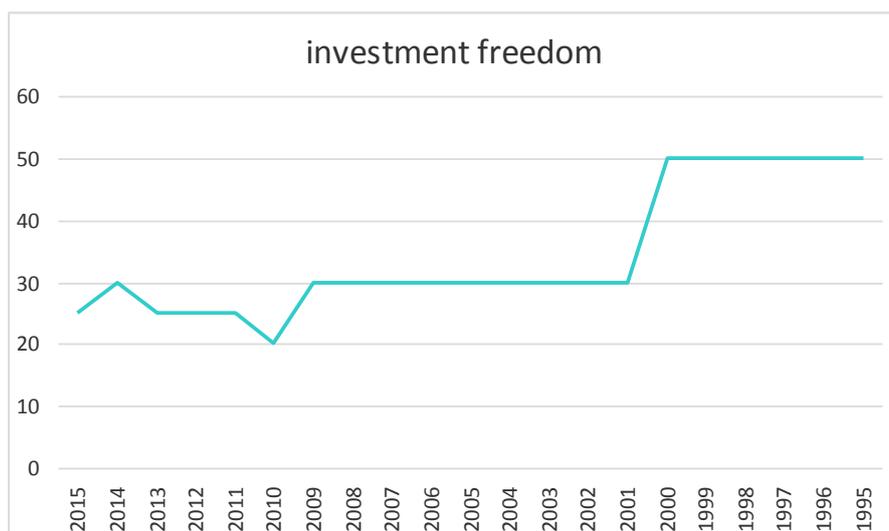
- No access for foreigners or residents 25 points less
- Available, but significantly restricted access 15 points less
- Available access, with some restrictions 5 points less

Capital controls

- No repatriation of profits, all transactions must be government-approved 25 points less
- Incoming and outgoing capital must be approved and faces some restrictions 15 points less
- Most transfers are approved, with some restrictions 5 points less

Moreover, no more than 20 points may be subtracted for security issues, lack of basic infrastructure for investments or other governmental policies indirectly affecting the investment process and limiting investment freedom (<http://www.heritage.org/index/open-markets>).

Investment freedom in China was constant, according to the chart, during 1995-2000, at a maximum level of 50 points for the last 20 years. Subsequently, investment freedom followed a strongly descending trend, due to government-imposed restrictions on invested capital, land ownership restrictions, sectoral investment restrictions, foreign currency exchange controls during 2001-2010 from 50 to 20 points. A slight recovery followed, due to the reforms implemented by the government in the investment environment during 2010-2015 and due to the waiver of sectoral restrictions on investments.



**Figure 3 - Investment freedom**

The efficiency of legislative regulations - The freedom of doing business - labour market freedom - monetary freedom

The freedom of doing business is an overall indicator of government efficiency in business regulation. The quantitative score is derived from a range of values regarding the difficulty in setting up, operating and dissolving a company. The score for the freedom of doing business in every country ranges from 0 to 100, with the maximum value corresponding to the most free business environment. The score is based on 10 factors with an equal weight, using the data in the Doing Business study of the World Bank:

- Setting up a company - procedures (number)
- Setting up a company - time (days)
- Setting up a company - cost (percent of income per capita)
- Setting up a company - minimum capital (percent of income per capita)
- Obtaining an approval - procedures (number)
- Obtaining an approval - time (days)
- Obtaining an approval - cost (percent of income per capita)
- Dissolving a company - time (years)
- Dissolving a company - cost (percent of ownership)
- Dissolving a company - recovery rate (cents/USD)

According to the chart below, the freedom of doing business in the last 20 years had a slightly descending trend, from 55 points in 1995 to 52 points in 2015. In our opinion, this shows that, due to excessive regulations and bureaucracy, it is still difficult to open, develop and dissolve a business. This discourages both foreign and local investors.

Labour market freedom had a strongly ascending trend in the last 20 years, from 0 in 1995 to 63 points in 2015. This evolution of labour market freedom currently places China among developed countries. Initially, in China, rural workers were not allowed to work in the urban environment and the other way round. Major legislative changes appeared in 2004, as the central government declared migration as a key vehicle for increasing the farmers' income and asked for the removal of all taxes for workers coming from the rural environment, as well as equal treatment for their children in schools. In the mid 2000s, China gradually created a functional labour market, allowing workers to become more and more mobile, and companies to allocate a higher share to labour market conditions in their decisions on employment and revenues. This was not easy and implied a major restructuring of the state sector, the establishment of a new social security system and a wider acceptance of the part of migrant workers in the economic development of China. Hence, we can state, with no doubt, that the labour market reform of 2004 reached its goals.

Monetary freedom considers price stability and inflation. It combines a price stability indicator with the assessment of price control. Both inflation, and price control distort markets. Price stability, with no macroeconomic intervention, represents the ideal situation for the free market. As we can see from the chart, monetary freedom has an ascending trend during 1995-2015, with values ranging from 61 to 75 points. In our opinion, this ascending trend shows the significant progresses of the Chinese economic system along the times in terms of price liberalisation and inflation control. During 1997-2000, we witness a strongly ascending trend of monetary freedom, which is, undoubtedly, the result of the reforms occurring with the financial crisis of Asia in 1997:

- the restructuring of the financial sector and system

- the adjustment of the interest rate and the foreign exchange rate
- the liberalisation of prices for agricultural products

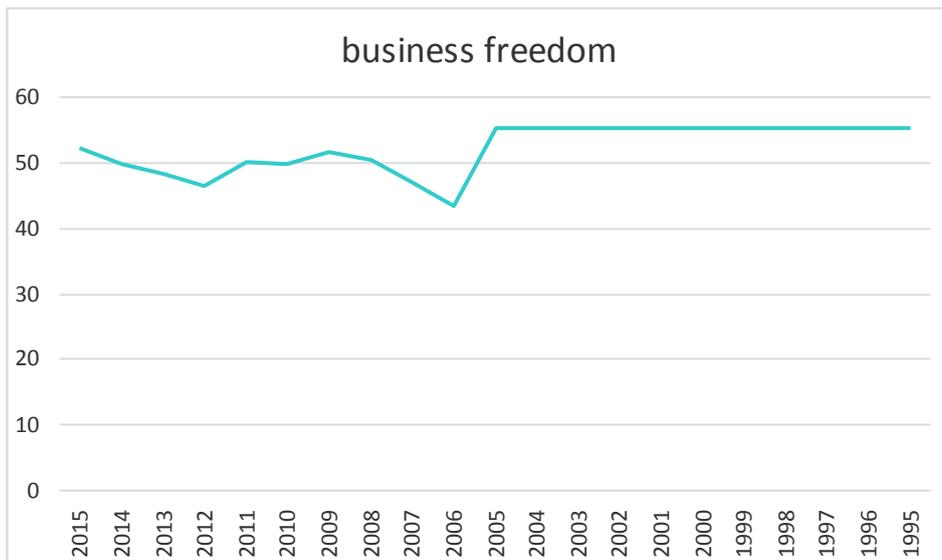


Figure 4 - Business freedom

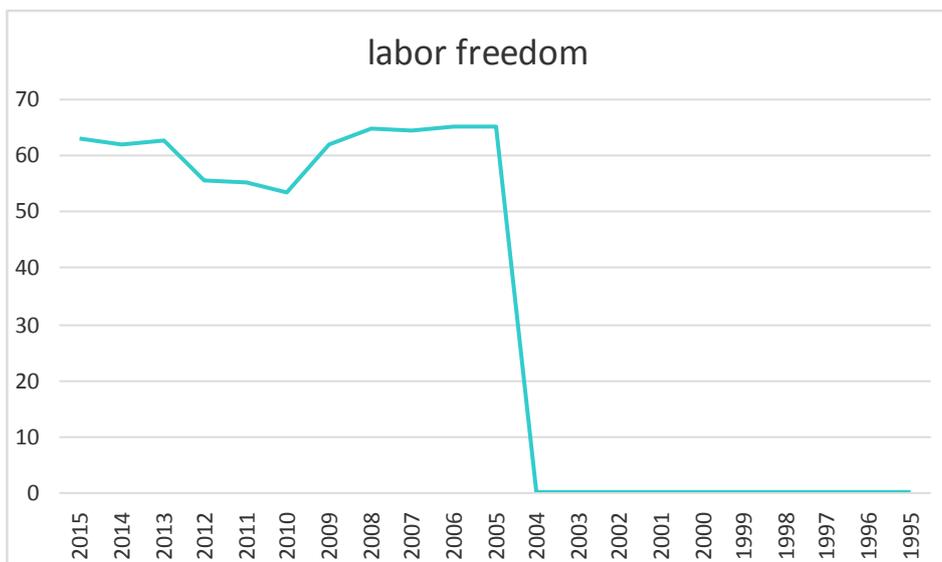


Figure 5 - Labor freedom

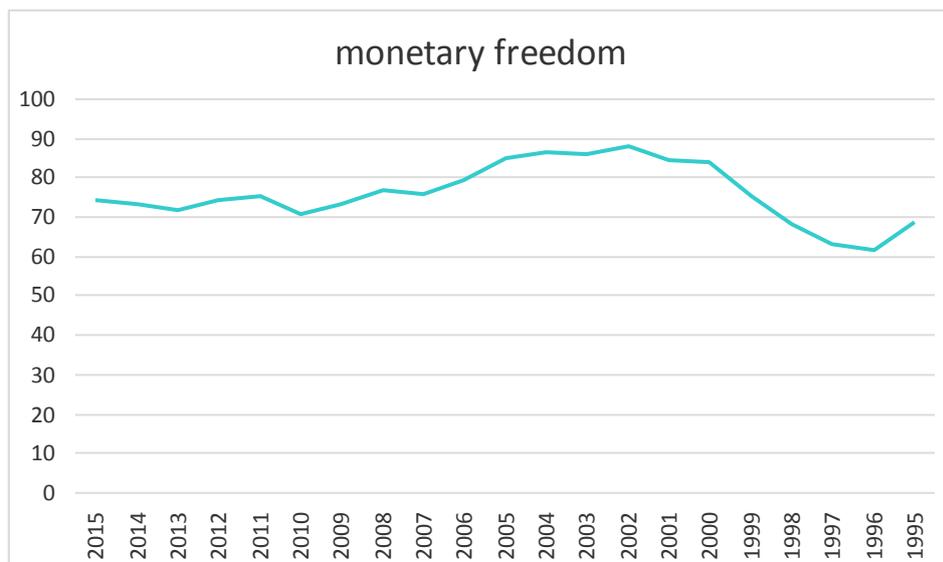


Figure 6 - Monetary freedom

II. LIMITATIONS IMPOSED BY THE GOVERNMENT - GOVERNMENTAL EXPENSES AND TAX FREEDOM

This component considers the level of governmental expenses as a percentage of the GDP. Governmental expenses, consumption and transfers included, take the whole score into account. Even though no attempt was made at identifying an optimum level of governmental expenses, the ideal level differs from one country to another, depending on factors ranging from culture and geography to the development level. However, several research (Zhang and Wang 2006, pp 233-242),; (Shirk 2007);(Young 1992); (Fischer1996 pp 390-395) has shown that excessive governmental expenses, that caused chronic budget deficits and resulted in the accumulation of sovereign debt, represent one of the strongest bottlenecks for economic dynamics.

The trend of governmental expenses in China is descending in the last 20 years, starting from 93 points in 1995 and up to 82 points in our days, which shows, in our opinion, that the state has understood that intervention in economy must be reduced and gradually gives way to the private sector, which is a strong signal of China's evolution towards a market economy. The reduction of governmental expenses is even more important since social protection in China increased significantly in these 20 years, as shown in our article "The Economic Analysis of the Social Security System in the Rural Environment of China"(http://www.aaresoc.org/icbm\_2013\_proceedings\_ab\_micuchina.html). According to the chart below, a sudden decrease in governmental expenses occurred in 2001, when China accessed the World Trade Organization and continued until 2006, with the end of the 5-year-period during which China had to align to the requirements of the organisation observing market economy principles. Total governmental expenses currently represent 24.8 of the GDP, while public debt accounts for 22%.(http://www.heritage.org/index/visualize?countries=china&type=3)

As shown by the chart below, tax freedom has remained quite constant in the last 20 years, with a variation of merely 6 points, which shows a significant improvement of this field in China. A descending trend of tax freedom is witnessed during 1998-2003, as this is correlated to an active tax policy of the government at that time, followed by an ascending trend during 2004-2009, when the authorities changed the tax policy, shifting from an active to a cautious approach. The maximum tax on the income of natural persons is 45% in China at this moment, with a 25% tax rate for legal entities. Other taxes include VAT and a building and land tax. The total level of taxes accounted for 19.4% of the GDP in the fiscal year 2014 ([www.heritage.org](http://www.heritage.org)).

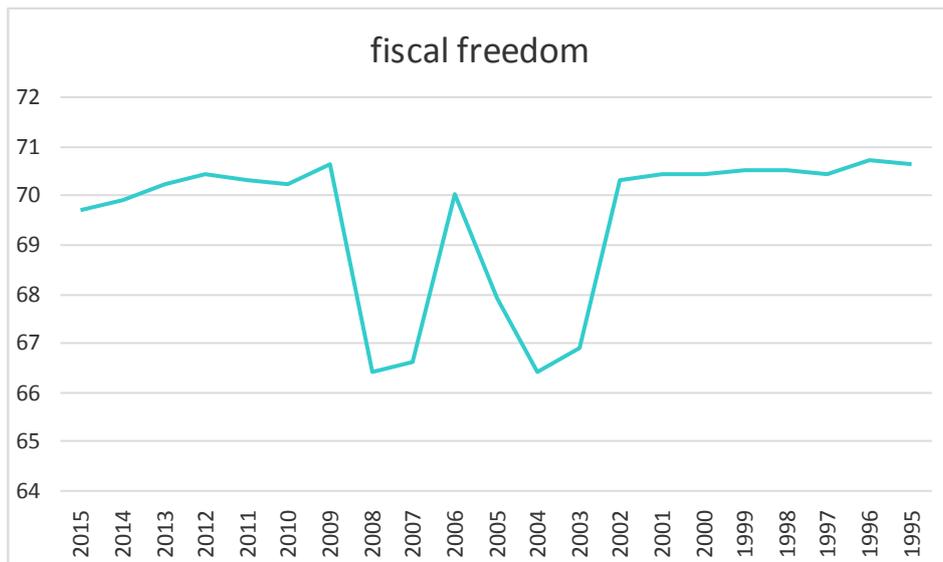


Figure 7 - Fiscal freedom

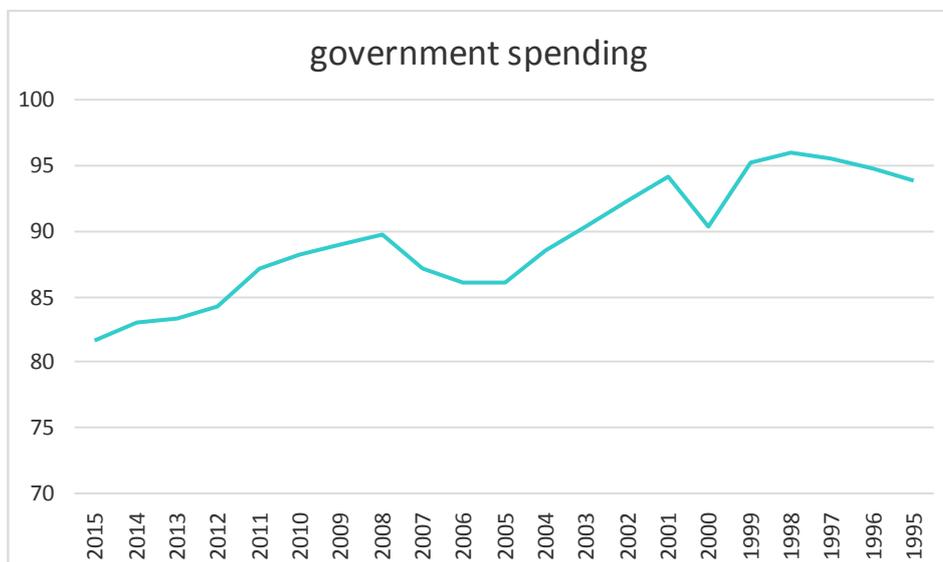


Figure 8 – Government spending

### III. RIGHTS ON OWNERSHIP AND CORRUPTION

The component referring to ownership rights is an assessment of a person's possibility to accumulate private property, guaranteed by clear laws, rigorously applied by the state. It measures the extent to which the laws of a country protect private ownership rights and to which the government imposes the application of such laws. Likewise, it assesses the probability that private ownership is expropriated and analyses the independence of the legal system, the presence of corruption in such system and the capacity of natural persons and legal entities of imposing the application of contracts.

The better the legislative protection of ownership, the higher the score of such country is; conversely, the higher the probability of expropriation by the government, the lower the score of the country is. Countries placed between the two categories are assigned an intermediate score.

Each country is scored according to the following criteria:

100 - Private ownership is guaranteed by the government. Courts impose the application of contracts in an efficient and quick way. The legal system punishes those who illegally seize private property. There is no corruption or expropriation.

90 - Private ownership is guaranteed by the government. Courts impose the application of contracts in an efficient way. The legal system punishes those who illegally seize private property. Corruption is almost non-existent, and expropriations are highly unlikely.

80 - Private ownership is guaranteed by the government. Courts impose the application of contracts, but with some delay. The legal system punishes those who illegally seize private property. Corruption is minimal, and expropriations are highly unlikely.

70 - Private ownership is guaranteed by the government. Courts have difficulties in imposing the application of contracts and act with some delay. Corruption is possible, but rare, and expropriations are unlikely.

60 - The imposition of ownership rights is difficult and takes place with some delay. Corruption is possible, but rare, and the legal system may be influenced by other branches of the government. Expropriations are unlikely.

50 - Courts are ineffective and act with delay. Corruption may be present, and the legal system may be influenced by other branches of the government. Expropriations are possible, but rare.

40 - Courts are completely ineffective, and delays are so long that they discourage the use of courts. Corruption is present, and the legal system is influenced by other branches of the government. Expropriations are possible.

30 - Ownership is protected to a low extent. Courts are completely ineffective. Corruption is extended, and the legal system is strongly influenced by other branches of the government. Expropriations are possible.

20 - Private ownership is protected to a low extent. Courts are so ineffective and corrupt, that understandings and arbitration outside the legal system are a current practice. Ownership rights are hard to impose. There is an extended corruption in the legal system. Expropriations are frequent.

10 - Private ownership is very seldom protected and almost all goods belong to the state. The country is facing such a chaos (e.g. because of an ongoing war), that ownership protection is almost impossible to impose. The corruption of the legal system is so high, that property is not effectively protected. Expropriations are frequent.

0 - Private ownership is outlawed and all the goods belong to the state. People are not entitled to sue someone else and do not have access to courts. Corruption is endemic.

As for ownership rights, China has a score ranging from 20 to 30 points, with a descending trend in the last 20 years, which shows that China currently has private ownership protected to a low extent. Even though legislation on private ownership has improved during this 20 years, it was not applied because of ineffective courts. Moreover, the descending trend (from 30 to 20 points) shows that courts are currently so ineffective and corrupt, that understandings and arbitration outside the legal system are a current practice. This practice, combined with a high corruption rate (China has only improved its score by 10 points - from 30 to 40 - in the last 20 years, according to the corruption index in the chart below, which shows that, despite all anti-corruption campaigns supported by the government, corruption is a phenomenon seriously affecting the Chinese economic system), renders the imposition of ownership rights almost impossible and encourages abusive expropriations.

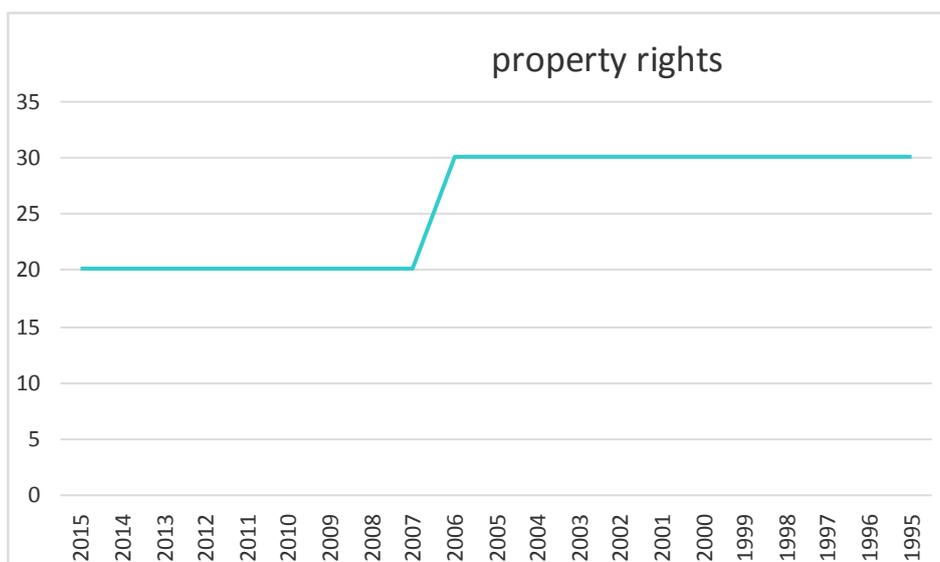


Figure 9 - Property rights

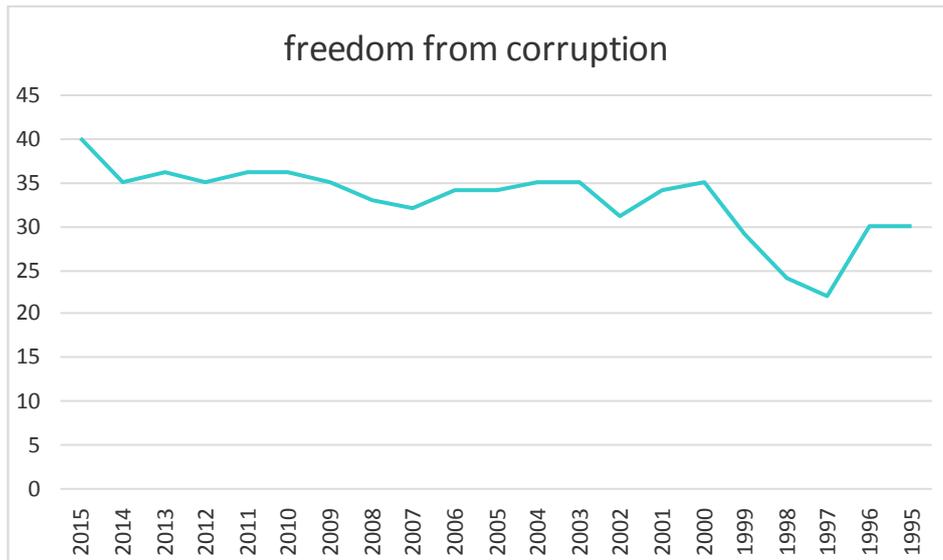


Figure 10 – Freedom from corruption



Figure 11 – Index of Economic Freedom China

The economic freedom index of China is 52.7 points, placing China's economy on the 139<sup>th</sup> place in the 2015 classification of [www.heritage.org](http://www.heritage.org). It is 0.2 points higher than in 2014, due to the slight improvements regarding: freedom in the business environment, workforce freedom, freedom obtained by fighting corruption, but these improvements were almost fully compensated by the decline in investment freedom and governmental expense control. In terms of regional position, China occupies the 30<sup>th</sup> place among the 42 countries in the Asia-Pacific region. Its general score is lower than global and regional averages.

In the last 5 years, the economic freedom index of China raised by less than 1 point according to [www.heritage.org](http://www.heritage.org), following the line of unequal and heterogeneous progresses from 1995 to our days. A major improvement was obtained regarding workforce freedom, which increased by 8.1 points from 2011 so far. Restrictions regarding the award of residence resulted in bottlenecks in the Chinese economic system, and significant gains in workforce freedom were compensated by a 5.5 point decrease in governmental expense control. The control of the Communist Party, witnessed at both a national and local level, keeps undermining confidence in the rule of law, stopping the development of an independent legal system, and the development of a free economic system, through government control on investment flows.

With all the reforms (Yang 1996) undertaken so far, opening a business in China is an operation taking about a month and including 11 procedures. Labour market regulations are quite flexible, but the implementation of labour law does not follow.

When it comes to market freedom, China is not very well off: export fees, subsidies for state companies or anti-dumping barriers are just some of the measures limiting trade (Cao and Yingyi et al 1999 pp103-131).

The government still controls foreign investments and the financial system at a close range. In this context, state companies have higher access to capital and lower financing costs than small and medium enterprises, which still have problems in accessing loans.

On balance, in the last 20 years, the economic freedom index of China had a variation of only 0.7 points, increasing from 52 points in 1995 to 52.7 in 2015. This score classifies the Chinese economy as an "economy mostly deprived from freedom". In our opinion, this variation proves that the Chinese economic system is still restrained by the regulations imposed by the Communist Party and that, despite the economic reforms undertaken along the times, real economic freedom is a remote goal.

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