The Importance of Property Rights for China's Future

The government could ensure continued prosperity by supporting freer markets and freer people

By James A. Dorn

January 9, 2015

For the first time since the 1997 Asian Financial Crisis China may fail to meet its real GDP growth target for a given year, which in 2014 was set at 7.5 percent. If the growth figure comes in at 7.3 percent, as expected, Beijing is likely to lower the target for 2015 to 7 percent. That is a far cry from the double-digit growth experienced for more than three decades following the 1978 opening to the outside world.

President Xi Jinping and Premier Li Keqiang have called for rebalancing the economy and structural reforms, with the recognition that slower, more sustainable high-quality growth is consistent with the "China Dream" of all-round development. But that dream could turn into a nightmare if political factors prevent fundamental reform, especially a just rule of law that protects and expands private property rights, including freedom of expression.

Economic life is predicated on voluntary exchange, which in turn depends on well-defined private property rights. Trust is based on reputation and promises kept, which means the power of government and the law must be used to safeguard people and property. A government with limited power enhances personal and economic freedom, and provides individuals with a wider range of choices than under top-down planning and control.

China has made significant progress in liberalizing markets and growing the private sector, but much still needs to be done to shift responsibility from the state to the market – particularly in the financial sector. The large state-owned banks obey government officials and cannot go bankrupt. The allocation of credit is still heavily politicized, and state-owned enterprises are first in line. Lending rates are set by the People's Bank of China, which is under state control and thus subject to the rule of men, not rule of law.

Recent actions by the central bank have pushed the stock market to new highs and should help the sagging property market, but have done nothing to restructure the financial system or privatize state-owned enterprises. The decrease in the benchmark lending rate will help incentivize the mortgage market, but the large excess capacity will persist. Likewise, the injection of about US$ 65 billion into the banking system in the form of short-term loans and another US$ 242 billion from the effective reduction of banks' reserve-requirement ratios – by widening the deposit base and allowing the additional deposits, from asset management funds and securities firms, to be lent out – will help stimulate the stock market and prop up state-owned banks, but do nothing to correct the misallocation of credit and promote "high-quality" growth.

China's top leaders are cognizant of the fact that money creation is not the source of real economic growth, and they seek to improve total factor productivity by increasing efficiency and structural reforms. The latter, however, will require a deeper understanding and appreciation of the primacy of property rights in expanding the range of choices open to individuals, which is the best measure of economic development – as Peter Bauer noted in his classic Economic Analysis and Policy in Underdeveloped Countries (1957).

Many economists have examined the relationship between property rights and economic development. One of the pioneers of that literature was the late Bernhard Heitger, a researcher at the Kiel Institute for World Economics. In a path-breaking article in the Cato Journal (winter 2004), Heitger distinguished between proximate and ultimate determinants of economic growth. Using data from an international cross-section of countries for 1975–95, he found that "a doubling of the property rights index more than doubles per capita income" and "that more secure property rights significantly raise the accumulation of physical and human capital."

In the yin and yang of economic development, China could gain ground by expanding private property rights and opening capital markets. If effective, those reforms would reverse capital outflows and help stabilize financial markets. Allowing more freedom and holding individuals fully responsible for their choices would be the surest path toward harmony and prosperity.

The problem is overcoming political obstacles to the loss of government power and the rise of a true market system. Vested interests who gain from state intervention are deeply embedded in China's socialist culture. Weeding them out will require strong and enlightened leadership.

Current leaders could draw important lessons from the great Han historian Sima Qian who in his Records of the Historian wrote: "There is no need to wait for government orders … When all work willingly at their trade, just as water flows ceaselessly downhill day and night, things will appear unsought and people will produce them without being asked. For clearly this accords with the Way and is in keeping with nature."

China managed to dodge the 2008 financial crisis by engineering a massive government spending spree and a rapid credit expansion. The property market boom has halted and the reality of a debt overhang is overshadowing future growth. The new "mini stimulus" is designed to mitigate financial instability but could easily exacerbate it. The danger is that if a crisis does appear, fundamental reform could be put on the back burner – and the power of government increase.

The challenge is to begin building the institutional infrastructure to support freer markets and freer people, with the security of private property rights at the center of that architecture.

James A. Dorn is vice president for monetary studies and a senior fellow at the Cato institute in Washington