

The Genesis and Evolution of China's Economic Liberalization

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August 22, 2016

CATO WORKING PAPER

No. 38



1000 Massachusetts Avenue NW
Washington DC 20001

*Cato Working Papers are intended to circulate research in progress for comment and discussion.
Available at www.cato.org/workingpapers.*

China has made much progress since it first opened to the outside world in 1978 under the guidance of paramount leader Deng Xiaoping. The devastation caused by Mao Zedong during the Great Leap Forward (1958–60), the Great Famine (1959–61), and the Cultural Revolution (1966–76) led Deng to rethink Marxist ideology and central planning. Rather than adhering to Chairman Mao’s “Little Red Book” and engaging in class struggle, Deng elevated economic development to be the primary goal of socialism. His vision of “market socialism with Chinese characteristics”—and his mantra, “Seek truth from facts”—paved the way for the emergence of the nonstate sector and the return of private entrepreneurs. The success of that vision is evident from the fact that China is now the world’s largest trading nation and the second largest economy.

This article tells the story of how China’s pro-market reforms were initiated and continued despite many bumps in the road. What is striking is that many of the reforms began at the local level and were motivated by the desire for greater economic freedom. Entrenched interests opposed departing from state-led development under the plan, but courageous individuals were willing to experiment with market alternatives to increase their freedom and prosperity.

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This bottom-up reform movement, which might be called “spontaneous marketization,” eventually led to the creation of a vibrant market economy sanctioned by the state. It would be misleading, however, to think that China has established a genuine free-market economy. Such a change would require limited government, widespread private property rights enforced by an independent judiciary, and the safeguarding of basic human rights.

There is still no free market for ideas, and state planning is far from dead. The Chinese Communist Party (CCP) continues to hold a monopoly on political power and to thwart criticism. President Xi Jinping made it clear in his remarks at the party’s 95th anniversary (July 1, 2016) that Marxism, not liberalism, is the bedrock of China’s political regime: “Turning our backs or abandoning Marxism means that our party would lose its soul and direction” (Wong 2016).

Initially the goal of China’s reform movement was to improve the performance of state-owned enterprises (SOEs). However, the nonstate sector, including private enterprises, became the engine for creating new wealth and employment as constraints on entrepreneurship and trade were gradually relaxed. But even before they were relaxed, brave individuals were willing to violate the law by engaging in private enterprise.

This article begins with the state of China’s economic and social life under Mao and proceeds to examine the genesis of economic reform that took place between Mao’s death in September 1976 and the Third Plenum of the Eleventh Central Committee of the CCP in December 1978, which is considered the official start of

Deng's economic liberalization. We then investigate the unfolding of reforms from 1978 to the present, what motivated those reforms, and the prospect for future reform. The focal point will be the quest for economic freedom and the relation between the state and the market in the process of development.

Economic and Social Life under Mao

The system of state control of both economic and social life under Mao deprived the Chinese people of life, liberty, and happiness. The CCP repressed the free flow of information and tailored data to fit Mao's ambitions to make China self-sufficient in grain and steel, only to result in mass starvation and a huge misallocation of resources. The internal passport system (*hukou*) restricted peasants from leaving the countryside and made it difficult to exchange information as well as goods and services. Families were destroyed by the large-scale communes that took the place of smaller collectives. The Great Proletarian Cultural Revolution turned everyday life upside down as children turned on their parents and trust was lost.

Jasper Becker (1998) gives a penetrating account of life under Mao's repressive regime:

- With the implementation of the internal passport in 1956, "the peasant could no longer travel without permission to attend fairs, or to seek work outside the village in slack seasons. News from the outside world was no longer brought by pedlars, strolling beggars, wandering musicians and mendicant priests" (p. 52).
- In the same year, collectives were formed with the aim of increasing grain production at any cost. That obsession along with the *hukou* "discouraged

handicrafts like embroidery or woodcarving that had been a part of peasant culture. All the small-scale private enterprises . . . withered and died, leaving the peasants dependent on what the state could supply from its factories” (ibid.).

- The collectivization of agriculture, including livestock, eroded incentives to practice responsible farming and breeding methods. “Animals that survived collectivization were now publicly owned, no one felt responsible for them. Peasants worked the animals to death” (p. 53).
- In 1958, collectives were combined into large-scale communes as Mao launched his Great Leap Forward campaign. The CCP “set out to achieve the abolition of all private property” and “destroy the family as an institution” (p. 105).

The purging of private entrepreneurs, the suppression of family life, and the fear of repression for any deviation from party orthodoxy uprooted civil society and crushed individualism. Thus, one reads in the *China Youth Journal* (September 27, 1958):

The framework of the individual family, which has existed for thousands of years, has been shattered for all time. . . . We must regard the People’s Commune as our family. . . . [T]he dearest people in the world are our parents, yet they cannot be compared with Chairman Mao and the Communist Party [Becker 1998: 105–6].

That mentality reached epic proportions during the Cultural Revolution as millions of youth were sent to the countryside for “re-education.”

The massive starvation during the Great Famine and the devastation caused by the Cultural Revolution left a lasting impression on Deng Xiaoping, who was purged from his CCP posts and experienced the imprisonment, torture, and crippling of his eldest son, Deng Pufang, by the Red Guards.

Deng would also not forget the absurdities engineered by Mao that made it difficult for peasants to recover from the famine, such as:

- “The Party outlawed all carpentry and handicrafts which were not undertaken by state-run units. Peasants in poor agricultural areas, who in the past had supplemented their income by carpentry, basket weaving and dozens of other trades, now had only farming on which to rely” (Becker 1998: 258).
- “In the name of egalitarianism, no one was allowed to be seen to prosper from activities such as raising poultry or selling vegetables, even if they were permitted, without attracting censure and punishments as ‘rich peasants.’ . . . Anyone caught slaughtering a pig without permission would be sentenced to one or even three years in prison” (ibid.).
- “Peasant militia also patrolled the villages to stop the villagers from indulging in the most harmless pursuits if they smacked of bourgeois individualism. The small pleasures of life, even playing cards, became crimes against the state” (ibid.).

These are but a few examples of the suppression of economic freedom and civil society under Mao.¹ The illusion of success and the mania for power prevented Mao from changing course. With no market for ideas and no free press, the truth was largely hidden. As Becker (1998: 79) notes, “Even when the

¹ For a more detailed account of Mao’s disastrous policies that took millions of lives, see Dikötter (2010, 2016).

famine was over, Mao's faith in his agricultural methods does not appear to have been shaken in the slightest by their evident failure."

The death of Mao in September 1976 opened the door for positive change. That change had already begun earlier in the shadow economy. Mao and his cronies may have banned private entrepreneurship and placed the CCP above the family, but people naturally rebel against coercion and want to make themselves better off. Those incentives led to black markets, not the abolition of markets; and to a hidden social fabric, not the end of culture. With Mao's death, the time was ripe to bring what Frank Dikötter (2016) called "the silent revolution" to the forefront and let markets gain ground.²

Early Reforms and the Reemergence of the Private Sector, 1976–78

By the time Deng Xiaoping took effective control of the CCP at the Third Plenum of the Eleventh Central Committee in December 1978, progress had already been made in moving from central planning to a market system. After Mao's death, Premier Hua Guofeng and others turned toward economic development as the primary focus of the CCP. That shift in attention led to the "Four Modernizations" and "Leap Forward" policies in 1976–77. More important, Hu Yaobang as head of the Central Party School and editor of *Theoretical Trends* fostered new thinking and debate. An article he helped publish in his journal, "Practice Is the Only Criterion for Testing Truth," gained CCP

²Dikötter (2016: chap. 21) provides compelling evidence that when legal markets were banned, black markets arose, especially in the poorest areas such as Yan'an, Luonan, and Pucheng in Shaanxi province, as early as 1974. Collective property was divided up among households, and produce was sold on the black market. Underground private factories sprung up and peasants engaged in various trades that were banned. Local cadres looked the other way or even assisted in the illegal behavior. Similar actions were witnessed in Hunan where peasants expanded their private plots by 50 percent in 1972. In Sichuan, farmers rented land in the early 1970s, and in Guangdong peasants returned to skilled work, such as embroidery, once trade restrictions for light industry were relaxed in 1972.

support for experimentation as an acceptable approach in moving from plan to market (Coase and Wang 2012: 41–42).

The most significant change during the 1976–78 period was the reemergence of the household responsibility system (*baochan daohu*). Earlier attempts by farmers to escape the vice grip of collectivization and gain autonomy were made in 1956–57, 1961–62, and 1967, but all failed as Mao and his cadres sought to maintain and strengthen their power (Zhou 1996: chap. 3). Finally, with Mao’s passing in 1976, the stage was set for “spontaneous privatization”—that is, grassroots, not centrally planned, privatization.

The household responsibility system was not officially adopted by the CCP until late 1981. However, after the death of Mao, areas devastated by the Great Leap Forward, the Great Famine, and the Cultural Revolution independently moved toward contracting out collectively owned land to individual households, who after satisfying the agreed upon quota could sell their surplus produce on private markets.³

The first case in post-Maoist China of allowing households to engage in private farming occurred in September 1976, in Nine Dragon Hill, a village in Pengxi County, Sichuan, which was part of the Qunli Commune. That experiment, which was initiated by Deng Tianyuan, party secretary of the commune, began by giving lower-quality land to two production teams. When crop yields on marginal private plots turned out to be three times higher than on more fertile collective plots, the experiment spread to the

³ For a useful summary of the origins and nature of the household responsibility system, see Tian (2009). More detailed accounts can be found in Lin (1987) and Zhou (1996).

entire commune. However, since spontaneous privatization was illegal, it was kept secret until 1979 (Coase and Wang 2012: 46–47).

In November 1977, Wan Li, the first party secretary of Anhui province, supported adopting the “Provincial Party Committee Six-Point Proposal” to address the dire plight of agriculture and continued starvation under the commune system. Point six of that program would assign land to production team members for their own use and allow them to sell surplus crops in local markets. Although such activities were illegal at the national level, Deng Xiaoping (then vice chairman of the Central Committee) and other officials understood the practicality of the Six-Point Proposal. The proposal was implemented and was successful in increasing production (Vogel 2011: 437–38).

Leftists, of course, were highly critical. Chen Yonggui, vice premier in charge of agriculture, strongly opposed Wan’s experiment with contracting down to the household level. The official press criticized Wan for turning toward capitalism and for rejecting the Dazhai Model that glorified state planning.⁴ In defending his experiment, Wan Li told Chen in November 1978: “You say you are speaking from the Dazhai experience; I say Dazhai is an ultra-leftist model. . . . You go your way and I’ll go mine. . . . As for who is right and who is wrong, let’s see which way works best” (Vogel 2011: 438).

In early February 1978, Deng visited Sichuan and informed Zhao Ziyang (then first party secretary) of Wan’s success under the Six-Point Proposal. Deng urged Zhao to follow suit, which he did by implementing a Twelve-Point Program designed to

⁴ The Dazhai Commune in Shanxi, which Chen Yonggui pioneered, gained national prominence during the Cultural Revolution when Mao praised it for self-reliance and nearly miraculous productivity. In reality, Chen had created a Potemkin village to deceive officials and others into believing that state ownership and forced collectivization were working (Dikötter 2016: 219, 231).

stimulate crop production by devolving control rights and responsibility to small groups, but not to households (Vogel 2011: 438).⁵

The most cited case of spontaneous privatization occurred in November 1978, when peasants from 18 households in Xiaogang Village (in Fengyang County, Anhui) secretly got together and agreed to engage in private production. They would still meet state and collective quotas, but use the land at their disposal for private gain. In their contract, they promised to take care of the children of local cadres in case they were disciplined for failing to prohibit decollectivization (Zhou 1996: 55–56). When farmers in Xiaogang were highly successful in increasing their yields and prospering from leaving the production teams to cultivate their own plots, nearby villagers had a strong incentive to join the movement (Coase and Wang 2012: 47).

Although Deng was not in a position to openly support the silent revolution taking place in rural areas in 1976–78, once he became paramount leader after the Third Plenum of the Eleventh Central Committee of the CCP in December 1978, he gradually sanctioned reforms that had begun at the local level.

The Evolution of Reforms under Deng Xiaoping, 1978–89

Following the Cultural Revolution in 1977, Deng helped launch the “Beijing Spring” movement in November 1978, which put a spotlight on Mao’s failed policies and allowed intellectuals the freedom to debate a new path for China. Although that freedom soon ended, it was clear that the disastrous effects of forced collectivization and central planning made economic reform essential.

⁵ In 1975, Zhao had already secretly given production teams more autonomy to decollectivize (Vogel 2011: 338).

After the Third Plenum, Deng was in a position to act on the tenet “Seek truth from facts.” One fact was evident: the relation between state and market had tilted too far toward comprehensive planning and away from competitive markets. By allowing markets to have more space in the state-directed economy, there was hope for greater freedom and prosperity. What Deng and his allies didn’t foresee was the spontaneous privatization and the growth of the non-state sector that would occur in the decade following the Third Plenum.

Four bottom-up reforms that occurred at the margins of the planned economy stand out: (1) the rise of the household responsibility system (HRS); (2) the creation of township and village enterprises (TVEs); (3) the emergence of private businesses in urban areas; and (4) the development of Special Economic Zones (SEZs).⁶

Household Responsibility System

The spontaneous spread of the household responsibility system motivated Beijing to relax the ban on private farming in 1980, and in October 1981 the National Work Conference helped establish the legitimacy of that arrangement by declaring it to be consistent with China’s socialist economy. In November 1981, the CCP secretariat formally recognized the HRS (Tian 2009: 1070) and in January 1982, the Central Committee of the CCP issued a “No. 1 policy document” that officially recognized the right of peasants to directly market their products, thus ending the state monopoly of the rural supply cooperatives (Huang 2008: 89–90; Coase and Wang 2012: 49). That policy

⁶ Coase and Wong (2012: chap. 3) discuss these “marginal revolutions” in detail. They conclude that “the four marginal revolutions—enacted by actors marginalized in Mao’s socialist economy—quickly gave birth to a dynamic private sector in China, freeing 800 million peasants from the state, allowing almost 20 million ‘returned youth’ in the cities to set up their own businesses, and creating a few spots for foreign and domestic entrepreneurs to flourish and inadvertently showcase the dynamism of capitalism” (p. 65).

change revealed the need for competition and private entrepreneurship in rural areas, and thus the failure of collectivization to create prosperity.

The relaxation of constraints on decollectivization led to a rapid transition to the household responsibility system. By the end of 1982, 80 percent of production teams were experimenting with various forms of contracting. The success of decentralization led the Central Committee to give further support to the HRS in January 1983, with the publication of its new Document No. 1. By the end of 1984, nearly 100 percent of rural households had joined the market-based contractual system (Tian 2009: 1070).

The ultimate success of the HRS can be attributed to the lessons farmers learned from earlier failures and the fact that “they made deals with individual cadres while seizing every opportunity to pursue their goals. . . . They literally bribed their way out from under [the repressive state system]” (Zhou 1996: 70). When local experiments were positive, they spread and eventually gained official recognition. “The most important and long-lasting effect of decollectivization was regained economic freedom” (Coase and Wang 2012: 76). That benefit can also be seen in the rise of TVEs.

Township and Village Enterprises

During the Cultural Revolution, the mantra was “Strike hard against the slightest sign of private ownership” (Becker 2000: 157). However, as farmers gained autonomy in the post-Mao era, they began creating small-scale enterprises at the village and township level—first in the coastal areas and then in more remote areas. It is not surprising that the entrepreneurial revolution began in the countryside. Weiyang Zhang, a pioneer of China’s reform movement, explains why: “As the household-contract

responsibility system was implemented and as rural markets were gradually liberalized, peasants obtained some freedom to do business” (Zhang 2015a: 176). Entrepreneurial farmers, who had little education but a drive to improve their lives and their families’ futures, took advantage of the cracks opening in the top-down system of planning to start TVEs, which officially were collectively owned, and rural *private* businesses.⁷

The number of TVEs exploded seven fold from 1978 to 1985, and reached 18.5 million by 1990, employing more than 92 million rural workers. The rural entrepreneurs/enterprises operated outside the state sector and “were the major driving force for economic growth in China during the 1980s” (Zhang 2015a: 177).⁸ The rise of TVEs reached a pinnacle in 1994 and declined thereafter as rural private enterprises took the high ground.

Unlike the commune and brigade enterprises that were set up by cadres during the Mao era, “the emergence of TVEs was not designed or guided by the state” (Wei 2003: 4). Instead,

The peasants took advantage of cheap land and labor, semi-formal or informal fund-pooling, the authority of the existing rural hierarchy or kinship, of local market and low transaction costs, of central government ignorance, and eroding control over income disparity since the adoption of the household responsibility system, and gradually shifted their resources into rural industry [ibid.].

⁷ The restriction on migration to urban areas under the *hukou* system meant that the vast population in rural areas had to rely on farming within the confines of the People’s Communes. As that system was dismantled, new opportunities arose for doing business in the nonstate sector. Central planning and SOEs dominated the urban landscape, leaving little space for marketization and private entrepreneurs. Thus, the freedom gained by peasants after the Third Plenum in 1978, gave them a head start in developing their entrepreneurial skills. See Zhang (2015a: 178) and Zhou (1996: chap. 5).

⁸ SOEs dominated the urban areas and left the countryside open to development by entrepreneurial farmers who created new markets to help relieve the shortages that were the legacy of central planning.

Deng (1987: 189) recognized the spontaneous nature of the rise and mushrooming of TVEs in the 1980s: “Our greatest success—and it is one we had by no means anticipated—has been the emergence of a large number of enterprises run by villages and townships. They were like a new force that just came into being spontaneously.” But he also understood that the leadership had played a supporting role: “If the Central Committee made any contribution . . . , it was only by laying down the correct policy of invigorating the domestic economy” (ibid.).

The general secretary of the CCP’s central committee at the time was Zhao Ziyang, who held that office from November 1, 1987 to June 23, 1989, and was premier from September 10, 1982 to November 24, 1987. Zhao was instrumental in changing the intellectual climate and allowing more freedom to debate and discuss ideas on how best to spur development. He even met with Milton Friedman in Beijing following the Cato’s Institute’s September 1988 conference in Shanghai. During the dialogue, Zhao revealed a firm grasp of the importance of clearly defined property rights, open markets, and what Joseph Schumpeter (1942) called “creative destruction” for making people better off. The general secretary told Friedman:

- “Property rights should not be left ambiguous; they should be made clear.”
- “We must reform the price system. . . . Price reform does not involve simply a readjustment of prices, but more importantly the formation of a mechanism under which prices are determined by the market.”

- “I am all for the idea that bankruptcy is a good thing. It allows the new to supersede the old.”⁹

Earlier, in his speech at the Thirteenth National Congress of the CCP, Zhao (1987) called for

- “[giving] play to market forces and free competition” (p. 25);
- “[creating] new types of institutions for commodity circulation, foreign trade and banking as well as networks of agencies to provide technology, information and service, all of which have full authority for management and full responsibility for their profits and losses” (p. 36); and
- “strengthening the socialist legal system” to provide “a fundamental guarantee against a recurrence of the ‘cultural revolution’ and for lasting political stability” (p. 59).

Both Deng and Zhao sought to build “socialism with Chinese characteristics,” not the “free private markets” that Friedman called for on his first visit to China in 1980 (Friedman 1989: 569). Yet Friedman recognized the political constraints facing those who sought to expand markets and limit the power of the state. Deng and Zhao get high marks for helping to navigate the economic reform movement through the political landmines set by special interests favoring the status quo.

⁹ The dialogue was published in Friedman (1990: chap. 9). The quoted passages can be found on pages 131, 128, and 129, respectively.

The focus on economic development, rather than ideological correctness—as captured by Deng’s famous dictum, “It doesn’t matter whether the cat is black or white, as long as it catches mice”—meant that local officials could gain ground and move up the CCP ladder by increasing economic growth. The chief way to do so was to allow experimentation with new ownership forms like the TVEs. Deng and Zhao implicitly sanctioned those experiments, and their support helped dissipate resistance among hardliners. Moreover, openness to new ideas about how to improve productivity and the “modification of the rules of the game” lowered “the costs of inducing the privileged groups to accept a change” in thinking about the role of markets (Cheung 1986: 56–59). At the local level, farmers individually made deals with cadres to gain access to collective land for private use.¹⁰

The legal recognition of private enterprises in 1988, and Deng Xiaoping’s political support during his post-Tiananmen Southern Tour in 1992, gave a boost to the nonstate sector. New ownership arrangements appeared and most TVEs were transformed into private enterprises. As Zhang (2015a: 178–79) notes, “Many local governments began to privatize their rural enterprises in various forms, such as by taking off ‘red caps,’ joint-stock corporatizations, or by simply selling out.” By 2000, TVEs were such a minor aspect of the rural economy that they were not even listed in the *China Statistical Yearbook* (p. 179).

Urban Private Enterprises

¹⁰ As Zhou (1996: 53) notes, “[Farmers] succeeded by making individual deals with individual cadres. They offered cadres more than the cadres expected. That broke the log jam.”

Spontaneous privatization also was occurring in cities. Young workers coming back from “re-education” in the countryside during the Cultural Revolution couldn’t find jobs in SOEs and began to “jump into the sea of private enterprise.” The CCP also helped fuel the private sector by allowing “self-employment,” with the proviso that firms could not hire more than 7 workers. Anything beyond that limit was deemed “exploitation” and was illegal. However, risk-taking entrepreneurs were willing to bribe local officials to look the other way (Zhang 2015b: 16). Corruption became an institutionalized part of China’s market socialism—that is, it became a mechanism for overcoming the contradiction between using the market to spur economic development and adhering to Marxist ideology.

In one well-known case, Nian Guangjiu, a small-business owner in Wuhu City, Anhui, expanded his workforce far beyond the legal limit. His success made local police hesitant to arrest him for “exploitation.” The case was taken to Deng Xiaoping who said, “Don’t arrest him. One person like Nian cannot shake socialism.” The word spread that Deng did not consider the private sector a threat and thus fostered entrepreneurial activity (Zhang 2015b: 17). The idea that private markets could work alongside state planning to promote development made its way into the Constitution of the People’s Republic of China in April 1988, when Article 11 was amended to read:

The State permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy. The State protects the lawful rights and interests of the private sector of the

economy, and exercises guidance, supervision and control over the private sector of the economy.¹¹

There were still major constraints on the private sector, but compared to Mao's ban against private enterprise the new era of private marketization was revolutionary. In 1978, the number of self-employed household businesses and sole proprietorships reached 140,000, and by 1981 had grown to 2.6 million (Coase and Wang 2012: 68). The private sector's success reflected the failure of SOEs to supply consumer goods that were in high demand as well as essential services.¹² Black markets had operated, as in the Soviet Union under central planning, but the gradual removal of legal barriers and ideological straitjackets allowed the reemergence of the private sector.

New thinking about marketization and urban enterprises was reflected in the Central Committee's "Decision on Reform and Economic Structure," which was adopted during the Third Plenary Session of the Twelfth Central Committee of the CCP in October 1984. That document cast aside Maoist rhetoric in favor of stating that the main goal of the CCP should be economic development—not class struggle—and that the market and price system should play a key role: "The full development of a commodity [i.e., market] economy is . . . a necessary requirement for the realization of the economic modernization of China"—and "price system reform is the key to the success of the reform of the whole economic system" (Wu 2005: 75–76).

Special Economic Zones

¹¹ An English translation of the PRC Constitution with amendments can be found at <http://english.people.com.cn/constitution/constitution.html>.

¹² Coase and Wang (2012: 68) point out that strong demand in the 1980s for consumer goods and services resulted in high incomes for small shop owners, traders, and owners of restaurants. Street vendors could earn more than scientists, and barbers could earn more than surgeons operating in the state sector.

One way to help rationalize the price system is to open the domestic economy to the forces of international competition. China took a small step in that direction in May 1980 when it decided to allow Guangdong and Fujian provinces to establish Special Economic Zones to attract foreign investors and integrate China into the global trading system. The first four SEZs were opened in the coastal cities of Shenzhen, Zhuhai, Shantou, and Xiamen. Fourteen additional SEZs were established in May 1984, including Wenzhou, which became the model for private-sector development in China (Wu 2005: 295–96).

The Wenzhou economy depended primarily on the private sector that developed rapidly after 1978. By 1984, Wenzhou, a coastal city in southern Zhejiang province, already had more than 130,000 family businesses. Those private firms produced the bulk of industrial output value and specialized in light industrial goods such as textiles, shoes, buttons, and electronic products. Entrepreneurship was a way of life—and Wenzhou flourished as markets deepened. With virtually no state assistance, the Wenzhou economy grew by 16 percent per year, on average, between 1978 and 1994 (Yu and Zhang 2008: 4).

Since private enterprises (*siying qiye*) were not legally recognized until 1988, owners of private businesses with eight or more employees had a strong incentive to avoid discriminatory treatment by paying to attach themselves to SOEs (i.e., becoming “hang-on household enterprises”) or by registering as collective enterprises—a practice known as “wearing a red hat.” Doing so would make it easier for them to obtain credit from state-owned banks. Nearly 62 percent of Wenzhou’s household enterprises

attached themselves to SOEs by the mid-1980s, and 80 percent of “neighborhood and district enterprises” registered as collectives (Tsai 2002: 130–31).

Other means of financing the growing private sector in Wenzhou emerged, including underground money houses, pawnshops, credit associations, private money houses, trade credit, and interpersonal lending. Those forms of “back-alley banking” allowed spontaneous privatization to occur in Wenzhou and other areas. Local cadres welcomed the new informal credit institutions and the newly created wealth brought about by robust private development. As one local official remarked, “If we had waited for the central government to allow certain practices, there would not be economic reform” (Tsai 2002: 121).¹³

As Wenzhou’s markets grew, there was increasing pressure to legally sanction the private alternatives to state financing. Kellee Tsai (2002: 120) cites one official at the Wenzhou City branch of the People’s Bank of China as saying, “The credit services performed by [unsanctioned] financial institutions in Wenzhou are essential for the development of market socialism. . . . Private money houses should be considered within the range of “popular” credit activities that are legal.”

From the perspective of economic freedom, Wenzhou offers a prime example of how individuals when given the opportunity to trade can lift themselves out of poverty without state intervention. As Ma Lei (1998: 6) reported,

¹³ See Tsai (2002: chap. 4) for a detailed discussion of the Wenzhou economic model and the emergence of private financing alternatives to state-owned banks. See also Yu and Zhang (2008) for an excellent analysis of the informal financial markets in Wenzhou and how they emerged as an example of Douglass North’s notion of “adaptive efficiency.”

The development of the private sector has fundamentally changed the way residents of Wenzhou look at the world. . . . Market forces have broadened the horizons of Wenzhou residents and educated them to the ways of the world. They have learned that in a market economy entrepreneurs frequently fail. But they have also learned that risk taking, when combined with foresight and hard work, can produce significant rewards. . . . Most important the people of Wenzhou realize . . . that one earns his living not through coercion or brute force but by serving others. That realization has produced a climate in which private industry and private organizations—including private schools—can thrive.

Similar stories can be told about the other SEZs. They opened China to the outside world and in so doing widened both the market for goods and services and the market for ideas—especially regarding alternatives to central planning and control.

The Jiang-Zhu Years: Building the Socialist Market Economy, 1992–2002

The decollectivization of agriculture with the HRS, the rise of TVEs, the emergence of urban private enterprises, and the creation of SEZs all contributed to making the first decade of China's economic reform a major stepping stone from plan to market—and thereby enhancing economic freedom for millions of people. Nearly everyone benefited from the reform movement: rural families, urban residents, SOEs protected by government largesse, and those who flocked to the newly created SEZs. Real incomes were rising and the future looked bright.¹⁴ That progress, however, was brutally interrupted by the crackdown in Tiananmen Square in June 1989.

¹⁴ Lau, Qian, and Roland (2000) refer to the 1978–88 period as “reform without losers.”

The student demonstrations began in April 1989 with the sudden death of Hu Yaobang, who was greatly revered for his stand against hardliners and his rehabilitation of those accused of being “Rightists.” Hu had been ousted in January 1987 as general secretary of the CCP by so-called conservatives who wanted to protect the status quo. One of the students’ demands was to restore Hu’s reputation within the Party. They also wanted greater freedom of the press and assembly—demands that threatened the CCP’s monopoly on power. The political crisis was also stirred up by rising inflation that threatened to reduce the growth in real incomes.

With the crackdown on June 4, 1989, conservatives gained the upper hand and Zhao Ziyang was placed under house arrest. The reform agenda, which the public still supported, was put on hold. However, as Naughton (2007: 99) points out, “The conservative attempts to roll back reforms were completely without success.” Inflation was tamed and “market forces corrected other imbalances in the economy with a speed that surprised conservatives and left planners far behind. As it became clear that the conservatives had no viable program, their support among the Communist Party elite began to crumble.” In 1992, Deng exercised his leadership and support for continuing the reform movement by taking his famous Southern Tour. He visited Shenzhen and other SEZs to praise the progress that had been made since he instituted the “open-door policy” a decade earlier. His slogan was: “It doesn’t matter if policies are labeled socialist or capitalist, so long as they foster development.” In October 1992, the 14th Congress of the CCP officially embraced the “socialist market economy” (Naughton 2007: 99–100).

Deng's strong support for liberalization reignited the reform movement under the guidance of Jiang Zemin, who was appointed general secretary of the CCP in 1989 (taking the place of Zhao Ziyang), and Zhu Rongji, who became vice premier in 1993 and premier in 1998.

Many leaders still viewed the market as a mechanism for strengthening socialism. They did not want to privatize SOEs, but rather to improve their performance by introducing a "managerial responsibility contract system." After meeting a state output quota, managers were given the right to make production and resource allocation decisions based on market criteria, and were rewarded for improved performance. In this way, it was hoped that SOEs could "grow out of the plan" (Coase and Wang 2012: 45; Naughton 1995). The introduction of the dual-track price reform in 1984 was also meant to make SOEs more efficient.

The rise of the private sector made it essential to improve the performance of SOEs, otherwise they would put a heavy burden on the state as losses mounted. Likewise, without a unified price system reflecting supply and demand, rather than planners' preferences, markets would lack clear signals about what to produce and how best to organize production.

The problem, however, is that changing the management system while retaining state ownership still leaves a lot of inefficiency. The lack of bankruptcy and the absence of private owners, who have the right to capitalize enterprise income by selling assets or shares of stock, meant that no one had a strong incentive to be as efficient as private, for-profit firms.

SOE Reform

In 1992, as the economic reform movement gained momentum, the debate over SOE reform heated up. “It was clear that there was no way to resolve the problems with SOEs under the constraints of state ownership” (Zhang 2015b: 19). As SOE losses mounted (overall losses for industrial SOEs exceeded profits in 1992), “fundamental thinking regarding SOEs began to change, and new thinking about privatizing them took hold” (p. 20). One of the key principles for reform adopted at the Third Plenary Session of the 14th National Congress in 1993 was “clearly established ownership.” The aim was to build “a modern enterprise system” and diversify property rights (ibid.).

The ownership reform began, as usual, at the local level. However, in 1995, Jiang Zemin made it clear that only small SOEs would be allowed to “privatize” while large ones would remain in the hands of the state.¹⁵ His idea of “grasping the large, releasing the small” (*zhua da fang xiao*) meant no radical ownership reform, but it did result in the transfer of many small- and medium-sized SOEs to the private sector and allowed large SOEs to diversify their ownership by transforming into joint-stock companies, especially after the 1997 Asian financial crisis (Zhang 2015b: 20).

The poor performance of SOEs due to the lack of private property rights and a “soft budget constraint”—that is, an implicit promise of a government bailout for insolvent SOEs—was a major factor in bringing about SOE ownership reform. The rapid increase in nonperforming loans from state-owned banks made reform of SOEs a high priority for Jiang Zemin and Zhu Rongji. By allowing debate in the market for

¹⁵ The word “privatize” was not used by officials or in government documents because of ideological constraints (Zhang 2015b: 21).

ideas, and through strong leadership, Jiang and Zhu were able to take significant steps toward improving the ownership structure and growing the nonstate sector. As Zhang (2015b: 21) notes, “In 1998 alone, about 20 million state employees were laid off when the state sector was restructured. Without Jiang and Zhu’s decisiveness and courage that task would have been impossible.”

The implementation of the Company Law in 1994 led to the conversion of SOEs into joint-stock companies (“corporatization”) and provided the legal basis for diverse ownership forms, including private firms.¹⁶ By 1996, the SOE share of industrial output value had fallen to 33 percent from 77 percent in 1978 (Naughton 2007: 300–1). In terms of value added in the business sector (including agriculture), the OECD (2005: 80–83) found that when the private sector is broadly defined in terms of control rights, it accounted for 61.5 percent of value added in 2002, a gain of 8 percentage points over 1998. Meanwhile, the public sector declined by 8 percentage points (Table 1) due to a fall in the value added by both state- and collective-controlled enterprises. The SOE reforms shut down or divested fully state-controlled firms and injected private minority stakes in state shareholding firms. Meanwhile, collectives were transitioning to the private sector or downsizing as regional competition increased and new opportunities arose outside the planned economy.

¹⁶ Besides SOEs directly owned by the state, collective enterprises, and private firms, there are a host of other ownership forms—for example, share cooperative enterprises, joint enterprises, limited liability corporations, and shareholding limited corporations. Meanwhile, private enterprises include sole proprietorships, partnerships, limited liability companies, shareholding limited companies, and individual businesses (Lardy 2014: 64–65).

TABLE 1

VALUE ADDED IN BUSINESS SECTOR BY FIRM OWNERSHIP (%)

Business Sector	1998	1999	2000	2001	2002	Change
Private Sector	53.5	54.9	56.3	59.4	61.5	+8
Public Sector	46.5	45.1	43.7	40.6	38.5	-8
State Controlled	33.1	33.0	33.1	31.2	29.9	-3.2
Collectively Controlled	13.4	12.1	10.6	9.4	8.6	-4.8

SOURCE: OECD (2005: 81).

Price Reform

The dual-track approach to reforming SOEs also was applied to the price system. Under the planned economy, China's prices were set by government fiat, not market forces. Consequently, prices did not reflect reality and led to highly inefficient use of scarce resources.¹⁷ Political/ideological constraints did not allow direct movement to market pricing; thus a mixed system of fixed state prices and flexible market prices emerged.

¹⁷ See Lin, Cai, and Li (1996: chaps. 2–3) for a detailed account of the distortions under China's centrally planned economy. In particular, see section 2.4 on the "Planned Resource-Allocation Mechanism," which elaborates on the pricing distortions that characterized the so-called shortage economy (pp. 38–44). Planners ignored the principle of comparative advantage and gave preferential treatment to heavy industry; they suppressed interest rates and other relative prices, creating shortages; and eliminated competition and private markets to ensure the planners preferences would prevail. See also Naughton (2007: chaps. 3 and 19) and Zhang (2015a: 240–46).

The first proposal for a dual-track price system was introduced in 1984 by Weiying Zhang, a young graduate economics student (Zhang 2015a: 391, n. 6). It led to a national debate over the role of prices in a socialist economy and eventually to reform. Before the official dual-track price system took effect after 1984, there was an illegal price system for goods and services that was parallel to the system of planned prices. After the Third Plenary Session of the 12th Central Committee of the CCP in October 1984, there was a gradual transition to market-based product prices. In a sense, “the dual-track price reform legalized the spontaneous dual-track price [system] that already existed” (Zhang 2015a: 239).

Price reform temporarily regressed as proponents of the planned economy gained ground following Tiananmen in 1989. But after Deng’s Southern Tour in 1992, there was no turning back. By 1999, 86 percent of producer goods, 95 percent of retail sales, and 83 percent of farm commodities were priced at competitively determined (market) prices (Table 2).

In his book, *The Logic of the Market*, Zhang draws various lessons from China’s price reform. The most important one in helping us understand “the evolution of economic systems” is to “know how to use the spontaneous power of the market.” His work shows “that the dual-track system was not the result of the meticulous design. . . . It arose spontaneously during the process of reform” (Zhang 2015a: 259). Leaders realized that they did not have sufficient information to set market-clearing prices, but they learned that market participants do have the relevant information and act on it. As illegal prices became legal and state controls were relaxed, a uniform market-pricing mechanism crowded out the inferior planned system (p. 260).

Other Reforms

There were other reforms during the Jiang-Zhu regime that moved China closer to a market economy: notably the 1993 decision to establish a “socialist market economic system” (a recognition of the growing importance of marketization in China’s development strategy); the 1996 decision to make the renminbi (also known as the yuan) fully convertible for current account transactions; the 1999 constitutional amendment to legitimize private ownership within the limits of the law; the 2001 decision to join the World Trade Organization (WTO); and the 2002 decision to invite private entrepreneurs to join the CCP.

Of those reforms, China’s accession to the WTO in December 2001 was a particularly significant event. It helped integrate China into the global economy and introduced China to a rules-based trade regime. However, as Nicholas Lardy (2002) has shown, China was well on its way toward global economic integration *before* entering the WTO. Tariff and nontariff barriers had come down significantly in the decade prior to entering the WTO, and trading rights (i.e., rights to export and import) were greatly extended.

The motivation behind China’s ambition to join the WTO was that top leaders thought it would provide an effective means to help put pressure on vested interests, like SOEs and state-owned banks, who sought protection from the growing non-state sector. By opening domestic producers and financial institutions to global competition, it was thought, consumers would be better served and economic efficiency would improve. Zhu Rongji and others increased their support after the Asian financial crisis

TABLE 2

SHARE OF Transactions CONDUCTED AT MARKET PRICES (%)

	1978	1985	1991	1995	1999
Producer Goods					
Market Prices	0	13	46	78	86
State Guided	0	23	18	6	4
State Fixed	100	64	36	16	10
Retail Sales					
Market Prices	3	34	69	89	95
State Guided	0	19	10	2	1
State Fixed	97	47	21	9	4
Farm Commodities					
Market Prices	6	40	58	79	83
State Guided	2	23	20	4	7
State fixed	93	37	22	17	9

SOURCE: OECD (2005: 29).

of 1997–98. They realized that “there was no viable alternative to the globalization of production” and that China “would benefit from greater participation in the trend” (Lardy

2002: 20).¹⁸ Opening the state sector to increased competition from foreign firms would help downsize government, and there would be losers—but Zhu was strong in his support of structural reform and moved ahead.

The Hu-Wen Era and the Global Financial Crisis

The leadership change in 2003, with the appointment of Hu Jintao as president and Wen Jiabao as premier, ushered in a new era in which the primary goal of development became rebalancing the economy to achieve sustainable economic growth and “all-round prosperity.” However, that key objective was deterred by an unforeseen event: the global financial crisis of 2008–9. A massive government “stimulus” program (RMB 4 trillion, \$586 billion) designed to rapidly increase fixed asset investment and maintain China’s export-led development model kept growth positive—but it slowed progress toward rebalancing and further liberalizing the economy. Rapid credit creation, with state-owned banks funneling a large share to SOEs, misallocated credit. Moreover, in the absence of market-determined interest rates and capital freedom, financial repression remained a serious problem.¹⁹

Prior to the financial crisis, Premier Wen gave an important speech at Harvard. In his remarks on December 10, 2003, he expressed optimism regarding China’s future. He noted that China had “found the right path of development”—namely, “building socialism with Chinese characteristics.” The essential nature of that path, he said, “is to mobilize all positive factors, emancipate and develop the productive forces, and respect

¹⁸ Lardy (2002: 20) points to the important role Long Yongtu, vice minister of foreign trade, played in making the case for integrating China into the global economy.

¹⁹ On the issue of financial repression, see Li (2001), Dorn (2001, 2006, 2008), and Lardy (2012: 78–88).

and protect the freedom of the Chinese people to pursue happiness.” He pointed to the success of China’s economic liberalization:

With deepening restructuring toward the socialist market economy . . . , there was gradual lifting of the former improper restrictions, visible and invisible, on people’s freedom in choice of occupation, mobility, enterprise, investment, information, travel, faith, and lifestyles. This has brought extensive and profound changes never seen before in China’s history [Wen 2003].

Most telling, Wen (2003) attributed China’s success “to the freedom-inspired creativity of the Chinese people.” In order to maintain that success, he argued, workers would need more capital, and to attract sufficient capital China would need more secure property rights: “Without effective protection of the citizens’ right to property, it will be difficult to attract and accumulate valuable capital.”

An important step was taken toward Wen’s goal when the National People’s Congress amended the PRC Constitution on March 14, 2004. Article 11 now proclaims: “The State encourages, supports and guides the development of the nonpublic sectors of the economy”; Article 13 holds that “Citizens’ lawful private property is inviolable.” However, the state reserved the right to ultimately control property rights in the “public interest,” and the absence of an independent judiciary meant that private property rights were still tenuous. Moreover, land is still owned by the state, although the Property Law of 2007 extended land-use rights through long-term leases and gave stronger protection to private property rights (Zhang 2008). Another positive development during the Jiang-Wen regime was the State Council’s adoption, in February 2005, of “Guidelines on Encouraging, Supporting and Guiding the Development of the Individual, Private, and

Other Non-Public Economic Sectors,” which made it easier to enter certain sectors (OECD 2005: 89, 119 n. 10).

When the global financial crisis threatened China’s strong growth record, there was increasing pressure to strengthen large SOEs in pillar industries—even though the private sector had been the driving force of China’s rise. However, as the global economy weakened and SOEs grew larger, China’s overcapacity in steel and other state-supported industries became evident. Special interests in favor of state protection became stronger and the pro-liberalization rhetoric of the leadership deviated from their actions. Compared to the Deng and Jiang-Zhu eras, which Weiyang Zhang argues were characterized by “good ideas and strong leadership” (in terms of advancing marketization and reducing the scope of the planned economy), the decade under Hu-Wen is best seen as a case of “wrong ideas and weak leadership” (Zhang 2015b: 11–12).²⁰

Nicholas Lardy, in his recent book *Markets over Mao*, questions “the view that state firms grew in prominence during the Hu-Wen decade.” In particular, he finds that “private firms continued to displace state firms throughout the period” (Lardy 2014: 2). Contrary to conventional wisdom, he also finds that “the access of private firms to bank credit has improved so much that on average new bank lending to private firms in 2010–12 was two-thirds more than to state firms” (p. 4). In his view, “China’s stimulus . . . was much less state-centric than is commonly charged” (p. 5). Nevertheless, Lardy (p. 107) notes that SOEs still held 48 percent of loans made by all financial institutions

²⁰ For Zhang’s case against the Hu-Wen regime, see Zhang (2015b: 23–29).

to enterprises in 2012, and certainly a large share of credit from *state-owned banks* still flows to SOEs.²¹

The role of private firms in China's development cannot be underestimated. Although state planning appears to have made a comeback during the Hu-Wen regime, especially after the financial crisis, Lardy (2012: 121) is correct to emphasize the continued importance of the private sector:

- “private firms have increasingly displaced state firms as the dominant source of output in most of manufacturing, mining, construction, wholesaling and retailing, and catering”;
- “private industrial firms consistently make more productive use of capital, as reflected in a much higher return on assets”;
- “private firms are responsible for virtually all of the growth of employment in urban China since the reform began”; and
- “private firms are now the most important contributor to China's still growing exports.”

We can certainly agree with Lardy (2012: 121) that “China's economic rise in the reform era is largely the story of the expanding role of markets and private enterprise.” Whether that rise continues will depend on the new leadership's commitment to fundamental reform of both the economic and legal system. As Steven N. S. Cheung (1982) first recognized, China would “go capitalist” by allowing the spontaneous

²¹ Lardy (2012: 107), however, is careful to note that if one considers total bank credit going to households in 2012, then “loans to enterprises amounted to only 61 percent of all loans.” Consequently, “loans to state-owned and state-controlled enterprises accounted for only 29 percent [48 percent x 61 percent] of all loans from the financial system in 2012.”

development of the market, but ultimate success requires privatization and the rule of law (Cheung 1990).

Xi Jinping and China's Future

In November 2012, Xi Jinping became general secretary of the CCP and chairman of China's Central Military Commission. He was viewed as a strong leader who would spur rebalancing and reignite economic liberalization. In March 2013, he consolidated his power by taking over as president, and Li Keqiang became the new premier. They hoped to implement policies that would achieve "all-round development" and realize "China's Dream" of becoming a wealthy and healthy nation. However, they still had to operate within the ideological constraints of the CCP and national socialism, without a free market for ideas.

The Xi-Li Agenda

The first sign of progress came in November 2013, following the Third Plenary Session of the CCP's 18th Central Committee, headed by Xi Jinping, when it announced the "Decision on Major Issues Concerning Comprehensively Deepening Reforms" (CCP Central Committee 2013). The 60-point roadmap calls for reform on a broad front but with a focus on economic reform: "Economic system reform is the focus of deepening the reform comprehensively. The underlying issue is how to strike a balance between the role of the government and that of the market, and let the market play the decisive role in allocating resources and let the government play its functions

better.”²² Resource allocation is to be improved by adhering to “market rules, market prices and market competition.” Officials should “encourage, support and guide the development of the non-public sector, and stimulate its dynamism and creativity.”

The new roadmap for reform also emphasized the importance of property rights: “Property rights are the core of ownership. We need to improve the modern property rights system with clear ownership, clear-cut rights and obligations, [and] strict protection.” In that regard, SOEs will be allowed “to develop into mixed enterprises,” and “a rural property rights transfer market” will be established to help ensure “the open, fair and procedure-based operation of rural property rights transfer.” The *hukou* system will also be reformed by allowing “the eligible population to move away from agriculture and become urban residents.”

Finally, there will be further efforts to “improve the mechanism for market-based Renminbi exchange rate formation, accelerate interest-rate liberalization, and . . . promote the opening of the capital market.”

While the blueprint is promising, the reality is that “if people are not allowed to freely debate how to reform the political system, then it will be impossible to develop the right ideas to implement this roadmap” (Zhang 2015b: 38).

Although President Xi has called for further economic liberalization, he has done little to advance privatization, the rule of law, or limited government. Instead, he has

²² Near the end of the first Five-Year Plan (1953–57), Gu Zhun, an economist at the Economics Institute of the Chinese Academy of Sciences, proposed that the market mechanism be given a key role in allocating resources. He was regarded as a heretic by those favoring central planning and labeled a “bourgeois Rightist.” Thus, his market-based development theory fell into a dark hole. See Wu (2005: 37–38).

focused on cracking down on any attempts to create a free market in ideas and seeks to strengthen large SOEs—by requiring that they operate on a commercial basis (an old socialist dream)—and plans to retain them as the heart of China’s socialist market economy (see Wei 2015).

The problem is that without private owners and the ultimate threat of bankruptcy, socialist enterprises have little incentive to be efficient. It is well-known that China’s private industrial firms have a much higher return on assets than SOEs (Lardy 2014: 121). In free private markets, firms are incentivized to be efficient and to maximize profits; firms that cannot pass the market test will fail. When government interferes with the competitive market process, the marketplace becomes politicized and the range of choices open to people becomes more limited.

Premier Li (2015) tells us that reforms to cut bureaucracy and decentralize power will help “get the relationship right between the government and the market.” However, without widespread privatization and a free market in ideas, as expounded by Coase and Wang (2012), state power—and the rent seeking that goes with it—will continue to be a drag on individual freedom and prosperity.

While the Party pays lip service to a free market in ideas, noting “there can never be an end to the need for the emancipation of individual thought” (*China Daily* 2013), Party doctrine strictly regulates that market. Consequently, under market socialism, there is bound to be ever-present tension between the individual and the state. As long as socialism trumps liberalism—in the classical sense of limited government and individual freedom—promises of further liberalization will be empty. The arbitrariness

and uncertainty of state action—and precariousness of private property and human rights—naturally breed tension. The harmony that officials promise is a false harmony designed by the state, not a true harmony spontaneously produced by limited government and freedom.

In a recent interview with the *Wall Street Journal*, President Xi expressed his view on the relationship between freedom and order: “Freedom is the purpose of order, and order the guarantee of freedom” (Xi 2015). There is some truth to this statement, but the real meaning is that China’s ruling elite will not tolerate dissent— individuals will be free to communicate ideas, but only those consistent with “socialist principles.”

This socialist vision contrasts sharply with that of market liberalism, which holds that freedom is not the *purpose* of order; it is the essential means to an emergent or spontaneous order. Simply put, voluntary exchange—based on the principle of freedom or nonintervention—expands the range of choices open to individuals and thus increases social wealth.²³ As James M. Buchanan (1982: 5) has argued, “The ‘order’ of the market emerges *only* from the *process* of voluntary exchange among the participating individuals.”

At a press conference following the Third Session of the 12th National People’s Congress, Premier Li Keqiang (2015) said, “We need to ensure that we run the country according to the law—everyone is equal before the law, and no one is above the law. . .

²³ Peter Bauer, a pioneer in development economics, held that “the principal objective and criterion of economic development” is to widen “the range of effective alternatives open to people” (Bauer 1957: 113). He understood that “the market order minimizes the power of individuals and groups forcibly to restrict the choices of other people,” and that under such a spontaneous order “the rich . . . usually owe their prosperity to activities which have widened the choices of their fellow men, including those of the poor” (Bauer 1984: 25).

. There must be no irresponsible actions or inaction on the part of government officials.” He wants people to “achieve full potential in their life,” and have the government “eliminate roadblocks and pave the way for people to tap their entrepreneurship.” Finally, he would fight corruption and rent-seeking by “institution-building.” Such rhetoric is encouraging, but at the same time we hear President Xi declare: “We in the Communist Party are firm Marxists and our party’s guiding thought is Marxism-Leninism, Mao Zedong Thought and Socialism with Chinese Characteristics” (Tatlow 2014).²⁴

China’s Future

Whether China evolves further toward the market will depend on whether Chinese leaders can “limit the power of government by adhering to a genuine constitutionalism and rule of law” (Xu 2015: 546). What now matters is whether Xi has good ideas for liberalization and can implement them, which will depend on whether he has the wherewithal to limit his own power. When he says, “An important goal for China’s current economic reform is to enable the market to play the decisive role in resource allocation and make the government better play its role,” he recognizes that China needs “to make good use of both the invisible hand and the visible hand” (Xi 2015). The problem is that the invisible hand doesn’t work well without the freedom that stems from widespread private property—including a free market for ideas—and limited government.

²⁴ President Xi Jinping has also said, “We need to fully make use of the great wisdom accumulated by the Chinese nation over the last 5,000 years” (Page 2015), but his attention has been on using classical literature to strengthen the Party’s adherence to socialism, not to promote the market’s invisible hand and freedom (see Dorn 2016).

Real change has come about in China because ordinary people have taken the initiative in moving from plan to market. When peasants and private entrepreneurs were successful, rulers took credit and sanctioned the spontaneous (bottom-up) privatization. Of course, “institutional development needs to fit initial conditions and to be made compatible with the interests of ruling groups” (Qian 2003: 331). China’s dual-track system of moving from plan to market was successful in that regard.²⁵ Moreover, as Oi and Walder (1999b: 19) note, the evolution of property rights in China has resulted from an interplay between local officials and market forces: the gradual movement from public to private or quasi-private ownership “occurred only partially as a result of explicit reforms of ownership, and . . . continued without repeated intervention by central officials seeking to implement a reform blueprint.”²⁶

Although ordinary people took the initiative to move outside the state sector, first in agriculture and later in industry and trade, the primary factor for China’s successful reform movement, especially from 1978 to 2002, was the pairing of right ideas and strong leadership. Deng Xiaoping, Zhao Ziyang, Jiang Zemin, Zhu Rongji, and a host of other leaders—who were influenced by intellectuals sympathetic to the market mechanism and who recognized the failure of central planning—were instrumental in promoting new ways of thinking about economic organization and leading the way from plan to market.²⁷

²⁵ See Qian (2003: 307–10) for a comprehensive view of the dual-track approach to market liberalization in China, as applied to agricultural, industrial, and labor markets.

²⁶ The case studies in Oi and Walder (1999a) provide ample evidence that the emergence of the nonstate sector, though often “hidden,” required cooperation between local officials and private parties who sought to improve their circumstances.

²⁷ Weiyang Zhang (2015) provides an in-depth analysis of the clash between reformers and conservatives in the transition from plan to market, and the importance of ideas and leadership in that struggle.

Today the information revolution offers the Chinese people a new opportunity to expose corruption and repression, even as the CCP tries to suppress the market for ideas. However, things do not look good at the moment. As Zhang (2015b: 38) points out, “There is every reason to be worried by the increasingly tight control of academic freedom and by the lack of publication and press freedom.” China should learn from Hong Kong, which is the freest economy in the world. In a recent survey, businesses ranked “the free flow of information” near the top of the list for why they moved to Hong Kong (Hong Kong Census and Statistics Department 2015: 23).

Markets function best when there are well-defined private property rights and the free flow of information. If China hopes to establish a world-class financial market and internationalize the renminbi, people need to be free to openly criticize existing institutions and search for better alternatives. The history of China’s economic reforms since 1978 illustrates that experimentation with market-based development—spontaneous marketization—is a proven means to advance liberty and prosperity. Blocking the free flow of information will slow China’s advance by increasing uncertainty and the tension between the individual and the state.

Conclusion

China has come a long way since the days when entrepreneurs were banned and central planning dominated economic life. Today entrepreneurship is taught in universities, markets set most prices, and trade is seen as the way to prosperity. In Chengdu, the capital of Sichuan Province, people exchange ideas about entrepreneurship in ancient teahouses. The Rongchuang Teahouse “organizes road

shows and entrepreneurship contests.” It also provides a large space for “one-stop service for selecting, breeding, incubating, and financing entrepreneurial projects.” Budding entrepreneurs in Chengdu can now obtain a business license in as little as one day.²⁸

The Chinese economy, however, is complex in the play between plan and market. State ownership is still prevalent and investment planning prominent. In such an environment, people seek to make themselves better off by learning how to “play the game” and evade roadblocks to market exchange. A good example is in the area of E-commerce, where start-up firms work within the framework of monopoly platforms and the platform providers, like Alibaba and Tencent, are active in making regulations that satisfy government bureaucrats as well as the operators. Rent seeking goes hand-in-hand with entrepreneurship in China. As Chen and Ku (2016) explain, “Rent seeking in the real economy creates distortions and hidden opportunities that nourish innovations in the Internet sector.”

To normalize markets in China, institutional change is critical. Market socialism needs to be transformed into market liberalism with well-defined and protected private property rights. Leading reformers such as Wu Jinglian recognize that “all the policies encouraging the development of the private sector that are beneficial to the national economy and people’s livelihood must be earnestly implemented; all the rules and regulations prejudiced against nonstate enterprises must be abolished” (Wu 2005: 438). More important, Weiyong Zhang (2015a: 109), the architect of dual-track pricing,

²⁸ See “Makers’ Grow by 680 People per Day: Chengdu Becomes City of ‘Entrepreneurship’” (Chengdu Government 2016).

understands that “the progress of humanity has been a continuous transition to the logic of the market,” which is the logic of freedom.

China has opened to the outside world and moved far along the road to a genuine market economy, but much remains to be done—especially the creation of a free market for ideas. Doing so will require fundamental political change because any advancement of free speech is a threat to those in power. In this struggle between state and market, the primacy of limited government over democratic rule should be kept in mind. Also, the importance of the information age for China’s future should not be underestimated. Grassroots movements have never had greater leverage than at present.

The main lesson from examining the genesis and evolution of China’s reform movement since 1978 is that the spontaneous nature of many of China’s key reforms, which were later sanctioned by the state, illustrate that if the government gets out of the way and allows experimentation with market-friendly institutions that reward productive activity, there will be a virtuous circle.

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