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How China Became Capitalist

BY RONALD COASE AND NING WANG

No one foresaw that the "socialist modernization" that the post-Mao Chinese government launched would in 30 years turn into what scholars today have called China's great economic transformation. How the actions of Chinese peasants, workers, scholars, and policymakers coalesce into this unintended consequence is the story we tried to capture. Today, we don't need to present any statistical data to convince you the rise of the Chinese economy, even though China still faces enormous challenges ahead. Many Chinese are still poor, far fewer Chinese have access to clean water than to cell phones, and they still face many hurdles in protecting their rights and exercising their freedom. Nonetheless, China has been transformed from the inside out over the past 35 years. This transformation is the story of our time. The struggle of China, in other words, is the struggle of the world.

Against conventional wisdom, we take the end of 1976 as the start of post-Mao reform and argue that China basically became a market economy by the end of the 90s before it joined the World Trade Organization in 2001. In the new millennium, the Chinese economy has kept its growth momentum and become more integrated with the global economy. As an account of how China became capitalist, our book focuses mainly on the first two decades of reform. Within this time frame, our account is split into two parts by a dividing event, the 1989 Student Movement.

The first part of the story is a tale of two reforms. One was designed by Beijing; its goal was to revitalize the state sector and save socialism. The other resulted from grassroots initiatives. The state-led reform came in two phases. The first one started at the end of 1976 under Hua Guofeng. Hua was Mao's designated successor, who consolidated his power base after arresting

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Ed Crane's Freedom Legacy

The cause of limited government is enjoying a political resurgence, and it may even prevail on November 6. But if it fails on Election Day, the fault won't lie with Ed Crane, who has stepped down this month after 35 years building the Cato Institute and promoting free people and free markets.

With money from Wichita businessman and libertarian Charles Koch, Mr. Crane founded Cato in San Francisco in 1977 with a budget of $800,000 and a staff of 10. He reluctantly moved the think tank to Washington in 1981 to more effectively communicate the small-government case in the heart of Leviathan. Cato's annual budget is now $21 million with a staff of 127, and its scholars have led the battles for entitlement reform, regulatory restraint, free trade and lower taxes.

Unlike some leaders of the libertarian movement, Mr. Crane is not a dogmatist and allowed his scholars wide latitude. We've disagreed with Cato's isolationist approach to foreign policy, but its ideas and op-eds have regularly informed readers of these pages. Cato's annual conference on monetary policy is especially influential by airing debates over a subject typically ignored by most of the media and think tanks. Under Mr. Crane, Cato held the first conferences on free markets and the rule of law in China (1988) and Russia (1990).

Mr. Crane's final months at Cato were marred by an unfortunate row over control with Charles and David Koch. We're pleased that the battle has been settled with a new governance pact that organizes Cato like a more traditional nonprofit with a self-sustaining board. Mr. Crane is graciously retiring at age 68.

His able successor is the longtime and highly successful former CEO of BB&T bank, John Allison, who has plans for expansion but who will build on the foundation of Mr. Crane's broad shoulders.

On October 24, a *Wall Street Journal* editorial paid tribute to Edward H. Crane's "35 years building the Cato Institute and promoting free people and free markets." Crane stepped down as President and CEO in October and was succeeded by John A. Allison. **PAGE 4**

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the "Gang of Four" and ending the Cultural Revolution. Even though loyal to Mao, Hua was an economic modernizer. With full support of Deng Xiaoping and other Chinese leaders, Hua launched his economic program of modernization, which would be later disparaged as "the Leap Outward." Essentially, it was a state-led, investment-driven program, with a focus on heavy industry; it is a good example of what economists called "big-push industrialization." But the program lasted barely over two years. It was called off in early 1979, partly due to its own defects and partly due to leadership change: at the end of 1978 the Central Committee held a meeting, at which Deng Xiaoping and Chen Yun came back to power and Hua was no longer in charge.

Deng Xiaoping is widely known in the West. Ezra Vogel's recent biography has documented in detail Deng's role in China's reform. In comparison, Chen Yun is a shadowy figure. But Chen was China's top official in charge of economic affairs. He was the architect of China's first Five Year Plan in 1953 and a strong believer in central planning. Since he grew up and apprenticed in Shanghai before becoming a revolutionary, Chen also saw a limited but critical role for the private sector and market under socialism. Chen lost his position when Mao started the Great Leap Forward in 1958, which Chen opposed. He came back to power along with Deng at the end of 1978 and was handed the job of designing an economic reform program.

Chen believed that the Chinese economy had long suffered structural imbalance: too much investment in heavy industry relative to light industry and agriculture, and state sectors and planning being emphasized at the exclusion of private sectors and markets. In his view, Hua's economic program, which focused on heavy industry, made the Chinese economy worse. That's why Chen forcefully ended "the Leap Outward" against strong opposition from the State Council and imposed his economic policy. This marked the second round of Beijing-led reform. This round of

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state-led reform was two-fold: adjustment at the macro level and state-enterprise reform at the micro level. Structural adjustment was imposed across the economy. For example, more investment was channeled from capital goods to consumer goods production. More money was allocated to agriculture. The government raised the purchasing prices for agricultural products by more than 20 percent in 1979 and significantly increased grain import. Beijing also took steps to decentralize foreign trade and gave more fiscal autonomy to provincial governments. At the micro level, the emphasis was squarely placed on what was seen as the economic foundation of socialism, the state-owned enterprises. The strategy was to devolve some rights to state enterprises and allow them to keep some profits. Beginning in 1979 and throughout the 1980s, the Chinese government was preoccupied with incentivizing state enterprises.

REFORM ON THE MARGINS

There is no doubt that the post-Mao Chinese government pursued a series of reforms. But today, with the benefit of hindsight, we know that the economic forces that were really transforming the Chinese economy in the first decade of reform were private farming, township and village enterprises, private business in cities, and the Special Economic Zones. None of them was initiated from Beijing. They were marginal players operating outside the boundary of socialism. For these marginal forces, the Chinese government was happy to leave them alone as long as they did not threaten the state sector or challenge the Party's political power. This created a room for what we called the "marginal revolutions" that brought entrepreneurship and market forces back to China during the first decade of reform.

At a Cato Book Forum for *How China Became Capitalist*, NING WANG of Arizona State University spoke and was joined in a video presentation by coauthor RONALD COASE (left), a Nobel laureate from the University of Chicago. The two authors discussed China's extraordinary journey in transforming itself into a powerful economic force.

One such marginal revolution is private farming. Private farming was certainly not new in China. Before 1949, it had existed for millenia. In the early 1950s, Mao tried ruthlessly to collectivize farming. Some peasants believed in Mao and hoped collectivization would offer them a way out of poverty. After 20 years of collective farming and 40 million famine deaths, they knew better. Many went back to private farming after Mao died, even though Beijing was still trying to beef up the commune system. In September 1980 Beijing was forced to allow private farming in areas where "the people had lost their confidence in the collective." But once the floodgates of private farming were opened, it could no longer be controlled. By early 1982 it became a national policy. Chinese agriculture was decollectivized. Later in the official account of reform, Beijing would credit itself for launching agricultural reform. But the reform enacted by Beijing merely raised the purchasing prices of grain and increased grain import; private farming, which really transformed Chinese agriculture and freed Chinese peasants, did not come from Beijing.

Township and village enterprises were industrial operations located in rural areas. During the first two decades of reform, they were the most dynamic sector in the Chinese economy. Since they operated outside the state plan, they did not have guaranteed access to raw materials controlled by the state but had to purchase them from the black market at a higher price. They were also excluded from the state-controlled distribution system to sell their products, but had to hire their own sales teams to travel all over China to find markets for their products. In other words, they had to operate like real business firms. This is what they did. And it did not take long for them to outperform state enterprises, which had all the privileges and state protections that they simply stopped being enterprising.

The first private businesses in Chinese cities were started by people who did not have a job in the state sector. Most were city youths recently returned from the countryside. During Mao's era, 20 million middle school graduates (ranging from 15 to 18 years old) in cities were sent to the countryside partly because the government could not create enough jobs. After Mao died, they came back, but found no job in the state sector. Young, jobless, and restless, they took to the streets and even blocked the railway. This mounting pressure forced the government to open the door for self-employment. Private shops started to emerge in Chinese cities; they quickly ended state monopoly of the urban economy.

Among the four marginal revolutions, the Special Economic Zones were the most controversial. They were established to co-opt capitalism to save socialism. The idea was to allow them to experiment with the market economy, importing advanced technology and managerial know-how, selling goods to the global markets, creating jobs and stimulating economic growth. But the experiments were confined to a few enclaves and strictly controlled so that they would not undermine socialism elsewhere, and if the experiments failed, their damage to socialism would be negligible.

REGIONAL COMPETITION

The presence of two reforms was a defining feature of China's economic transition. The failure to separate the two is a main source of confusion in understanding China's reform. The Chinese government has understandably promulgated a state-centered account of reform, projecting itself as an omniscient designer and instigator of reform. The fact that the Chinese Communist Party has survived market reform, still monopolizes political power, and remains active in the economy has helped to sell the statist account of reform. But it was marginal revolutions that brought entrepreneurship and market forces back to China during the first decade of reform when the Chinese government was busy saving the state sector.

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The second part of our tale began in 1992 after Deng Xiaoping's southern tour. While marginal revolutions brought market forces back to China in the previous decade, regional competition became the main transformative force in the second decade, turning China into a market economy at the end of the century. Regional competition was not new; it existed in the first decade of reform. But then it created trade barriers at provincial borders and fragmented the Chinese economy. China implemented price reform in 1992, tax reform in 1994, and began to privatize state enterprises in the mid-1990s. These reform measures paved the way for the rise of a common national market, which was able to impose market discipline on all economic actors, turning regional competition into a transformative force.

Here, our account differs from the one presented by Huang Yasheng in his book, Capitalism with Chinese Characteristics. A controversial argument of Huang is that China was more capitalistic and entrepreneurial in the 1980s than in the 1990s. If the argument means that private entrepreneurship prevailed against the state in the 1980s, it is in full accord with our tale of "marginal revolutions." But if it suggests that China moved away from a free market economy in the second decade of reform, it misses a fundamental change in the economy in the 1990s; the emergence of a common national market, which was a precondition for regional competition to work.

Identified with repetitive investment, regional competition is often faulted for distorting comparative advantage and hindering economies of scale. A more nuanced pictured emerged in our account. What regional competition did was to translate China's advantage in space as a continental country into the high speed of industrialization. How this happened can best be seen from a Hayekian perspective, which stresses the growth of knowledge as the ultimate force driving economic change. In Mao's time, education was under attack and knowledge became a political liability; China isolated itself from the West and cut itself off from its own traditions. Mao's rad-

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ical ideology impoverished the Chinese economy and, worse, closed Chinese minds.

After Mao died, China re-embraced pragmatism. "Seeking truth from facts" became the Party's new guideline; getting rich became glorious. Then the most restrictive constraint for economic growth was the lack of knowledge. This included technical knowledge, knowledge about institutions—how various market-supporting institutions work, and local knowledge—what Hayek called "knowledge of the particular circumstances of time and place." The solution to this problem was found in regional competition. When China's 32 provinces, 282 municipalities, 2,862 counties, 19,522 towns and 14,677 villages threw themselves into an open competition for investment and for good ideas of developing the local economy, China became a gigantic laboratory where many different economic experiments were tried simultaneously. Knowledge of all kinds was created, discovered, and diffused fast. Through the growth of knowledge, the enormous scale of Chinese industrialization made its rapid speed possible.

CONCLUSION

Given our account of how China became capitalist, what can we say about the form of capitalism that has emerged in China? A persisting feature of China's market transition is the lack of political liberalization. This is not to say that the Chinese political system has stood still over the past 35 years. The Party has distanced itself from radical ideology; it is no longer communist except in name. In recent years, the internet has increasingly empowered the Chinese to exercise their political voice. Nonetheless, China remains ruled by a single political party.

This continuity hides a fundamental change in China's political reality. With the death of Deng Xiaoping, "strongman" politics was brought to a closure. Under Jiang Zemin and Hu Jintao, China is no longer ruled by a charismatic leader. In that sense, Chinese politics today is qualitatively different from the time of Mao and Deng. But the Chinese government has not come to terms with this political change on the ground; there have been few efforts at institution-building to prepare China for the new political reality.

The combination of rapid economic liberalization and seemingly unchanged politics has led many to characterize China's market economy as state-led, authoritarian capitalism, which many people have rightly recognized as fragile and unsustainable. When and how China will embrace democracy, and whether the Party will survive democratization, are the main questions asked about China's political future. In our book, a different perspective is offered. It provides a different diagnosis of the main flaw of the Chinese market economy: China has developed a robust market for goods, but it still lacks a free market for ideas.

The market for ideas points to an alternative way of thinking about China's political future. Our reasoning is mainly based on the following two considerations. First, multiparty competition does not work unless it is cultivated and disciplined by a free market for ideas, without which democracy can be easily hijacked by interest groups and undermined by the tyranny of the majority. The performance of democracy critically depends on the market for ideas, just like privatization depends on the market for capital assets. Second, multi-party competition had virtually no precedent in Chinese history. Indeed, the Chinese word for the "party" (党) has a strong negative connotation in traditional Chinese political thinking. "Forming a party and pursuing self-interest" (结党营私) has been consistently denounced as undermining the political ideal, which is "what is under heaven is for all" (天下为公). In contrast, the market for ideas has a deep and revered root in traditional Chinese thinking; "let one hundred schools of thought contend" has been respected as a political ideal since the time of Confucius. In our view, the market for ideas promises a more gradual and viable approach to rebuilding Chinese politics on the principles of tolerance, justice, and humility.

Over the past 35 years, China has embraced capitalism not just in the economy. *The Theory of Moral Sentiments* has more than a dozen Chinese translations; the book has won the heart and mind of premier Wen Jiabao. The message of Adam Smith resonates strongly with the Chinese, not least because of its striking affinity with the traditional Chinese thinking on economy and society. A surprising outcome of China's transition to capitalism is that China has found a way back to its own cultural roots.

"Seeking truth from facts" is a traditional Chinese teaching, which Deng Xiaoping mistakenly called the "essence of Marxism." But many facts are still covered in China because a free market for ideas does not exist yet. We are cautiously optimistic that China may well embrace a market for ideas in the decades to come, just like the way it embraced the market for goods in the recent past. As our modern economy becomes more and more knowledge-driven, the gains from free exchange of ideas are too great; the costs of suppressing it are too high.

China's embrace of both its history and globalization leads us to believe that Chinese capitalism, which just started its long journey, will be different. This is desirable not just for China, but for the West and everyone else as well. It is also desirable for the global market economy. Today, biodiversity is recognized as vital for sustaining our natural environment. Institutional diversity plays a similar role in keeping human society resilient. Capitalism will be much more robust if it's not a monopoly of the West, but flourishes in societies with different cultures, religions, histories, and political systems. While trade in the global market for goods makes war too expensive to fight, a global market for ideas can accommodate and thrive on the clash of ideas but steers us away from the clash of civilizations. ■