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## Challenges of China's Economic System for Economic Theory

By GREGORY C. CHOW\*

The challenges of the market economy in China for economic theory touch on four topics: private versus public ownership of assets, Western legal systems versus Eastern semiformal legal systems, individualism versus the collective good, and multiparty versus one-party political systems. I came in contact with these issues while advising the government of Taiwan in the 1960's and 1970's, and the government of mainland China in the 1980's and 1990's (see Chow, 1994 Ch. 4–5). Others have studied these issues as scholars, including Patrick Bolton (1990), Bolton and Philippe Aghion (1992), Masahiko Aoki and Hyung-Ki Kim (1995), and Oliver Hart (1995).

### I. Private versus Public Ownership

China is an interesting experimental station for both public and private enterprises, as state-owned enterprises coexist with collectively owned enterprises (many by township and villages) and private enterprises (owned individually, by foreign corporations, or jointly with foreign corporations). Some state-owned enterprises, especially those having joint ventures with foreign corporations, appear to be efficient, as they are financially independent and are making large profits. Many collectively owned township and village enterprises are successful in increasing output and making profits. The successful experience of the township and village enterprises in China is sufficient to challenge the dogma that only private enterprises in a capitalist economy can be efficient.

Most assets in China are publicly owned, by the central government, by provincial and local governments, and by villages as collectives. Incentive systems have been adopted to make the management of these assets efficient. The most prevalent is leasing, known as the "responsibility system." Notable examples are the leasing of land by the village to farm households and the leasing of enterprises of all kinds by different levels of government. The terms of the lease include fixed rents and forms of profit-sharing. In all cases there is a positive relation between profits of the enterprise and the economic benefits of the management and workers. Providing incentives for the management of publicly owned assets is a key to China's success.

In a private communication, Milton Friedman questioned the above statement: "Most assets in China are publicly owned." Two kinds of "assets" need to be distinguished. Land as an asset is publicly owned. The enterprise managed by a farm household using the land is privately owned. This private enterprise leases a piece of publicly owned land to produce and make profits, as in a capitalist society, but the government or village authority owns the piece of land under a Chinese socialist system. Publicly owned assets consist mainly of land, state enterprises, and township and village enterprises. The government can lease a state enterprise to a manager who operates it for profit. The advantages and disadvantages for the manager to own rather than to rent the enterprise from the government are discussed in Hart (1995).

In addition to managing existing assets, government units at different levels have created new enterprises. Even universities as public institutions have created and own enterprises, some selling research and consulting services, and others selling products produced in factories run by faculty members.

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An example of this outside China is Ex Libris, a library software firm owned by Hebrew University in Jerusalem. Ownership by a public institution in China confers advantages to the enterprise, including the institution's reputation, personnel, and physical assets, which the enterprise can share. Possible disadvantages of public ownership might be the social costs associated with monopoly power. However, publicly owned enterprises in China are subject to competition from other public enterprises and from private enterprises as well.

Theories to explain the efficiency of Chinese state enterprises are found in Theodore Groves et al. (1994, 1995), who appeal to the improved incentives provided for the management and workers of these enterprises. Operating losses in state enterprises may be the result of antiquated capital, slow adaptation of management to a new market environment, or the government's responsibility to provide employment to workers, and not of state-ownership per se. Causes of losses in Chinese state enterprises are studied by Athar Hussain and Juzhong Zhuang (1996).

Theories to explain the efficiency of township and village enterprises are found in Martin L. Weitzman and Chenggang Xu (1994), C. Chang and Y. Wang (1994), Jiahua Che (1996), and David D. Li (1996). Weitzman and Xu (1994) appeal to the cooperative nature of Chinese culture, Chang and Wang (1994) and Li (1996) to the economic power of local governments or their officials, and Che (1996) to the creditworthiness of local governments. Weitzman and Xu (1994) and Li (1996) allow for ownership rights being vague, an issue related to the subject of Section II. A related subject is corruption, as studied by Susanto Basu and Li (1996). Rewards to government officials could provide incentives not only to promote economic reform, as discussed in Roger H. Gordon and Li (1995), but also to facilitate enterprise operations.

Once the ownership of an enterprise is separated from its management, as in a modern corporation, the incentive of the management to pursue profits for the owners becomes problematic. Corporate governance issues in the context of public enterprises are important topics for research. Some important issues con-

cerning publicly versus privately owned enterprises are treated in Aoki and Kim (1995) and in Hart (1995). The latter provides a useful discussion of "Firms, Contracts and Financial Structure" and notes two features of an economic relationship (p. 3): "The first is that contracts are incomplete. The second is that, because of this, the *ex post* allocation of power (or control) matters. Here power refers roughly to the position of each party if the other party does not perform (e.g., if the other party behaves opportunistically)." Hart's theories are relevant for the topic of Section II on modern legal system versus the informal Chinese in terms of solving the *ex post* allocation of power and for explaining the possible advantages of the township and village enterprises. These advantages stem from the local government's power to enforce contracts and from the credibility of such a "public" enterprise in raising funds as compared with an entirely private enterprise.

## II. Modern Legal System

A modern legal system as practiced in a Western developed economy is sometimes considered essential for the proper functioning of a market economy. The non-Western legal system in China is considered deficient by Western investors and economists. Although it might be called a "semi-legal system," it is definitely a legal system, as law has been practiced in China for several thousand years. However, this system is different from legal systems in the West. One major difference is that under Chinese law a contract is enforced partly by an informal social relationship known as *guanxi*. *Guanxi* plays an important role in insuring that a contract is honored.

First, there is a question as to whether all contracts should be strictly enforced. An economic answer is that, given an objective function, there is some optimum degree for enforcing contracts to balance the costs and benefits. A formal model to determine the optimum degree would be useful. Second, granted that it is advantageous to have a certain contract enforced, there is the question of enforcement through legal means versus enforcement through *guanxi*. *Guanxi* is a network of human relationships which sets the

rules of behavior among the parties concerned. When applied to two individuals engaging in certain business dealings it is like a handshake accompanied by a verbal or written agreement for each party to do something in the future contingent on the occurrence of certain events. The events might involve the sale of certain merchandise for profit. The agreement stipulates how profits should be shared. The judicial system need not be relied upon to enforce such an agreement. The high cost of enforcement under the American legal system suggests that perhaps there is some advantage in enforcement partly by an informal network. Third, given the fact that not all contingencies can be anticipated and written down explicitly, how complete should a contract be? In areas where the contract is vague, should disputes be settled by legal means or by informal relations?

What explains the appearance of the semi-legal system (with the other half being supplied by the informal network) in China and some other Asian countries and the modern legal system that appeared in the West after the Industrial Revolution? What are the circumstances that make the informal system work? The Chinese government has been trying to modernize its legal system to make it resemble that of a Western country, partly for the convenience of Western investors and partly to enable Chinese producers and traders to enter the world market. This does not necessarily mean that the current legal system works poorly for China's internal economic development. At least the system is not so bad that it hindered the rapid economic growth that has taken place since 1978.

It would be interesting to study the economics of *guanxi* (see Janet Tai Landa and Jing Lu, 1997). *Guanxi* is a form of human capital. Having *guanxi* is like having knowledge of which friend would be helpful when needed, having a reputation similar to that conveyed by a college degree, and having a good credit rating. Developing *guanxi* is accumulating human capital just like getting a college degree or promoting a reputable brand name. The service from this form of human capital can supplement legal enforcement of contracts by social pressure. A formal model should explain the relative roles of legal enforcement of contracts and the enforcement through *guanxi*,

and the optimum combination of the two in a society.

People in China are sometimes considered insufficiently law-abiding, as in the case of violation of intellectual property rights. The optimum level of enforcement of patent rights in any economy is an interesting question. On the one hand, patent enforcement helps encourage technological innovations. But as a monopoly right, a patent discourages innovations which might infringe upon this right and makes the invented products more expensive to consumers. Opinions on the economic effects of patents differ. For example, the view of Almarin Phillips (1966 p. 302) is "that a weakening of the patent rights of large corporations ... would do little to hinder the 'Progress of Science and useful Arts' and, in some market situations, would be instrumental to these ends." Patents have been invented partly to serve the economic interests of industrial monopolies at the expense of the common people. For example, patent protection for American pharmaceutical companies might have harmful effects in restricting the sales of drugs which cannot be offset by the benefits in encouraging the development of new drugs.

Less than strict enforcement of a law can sometimes be beneficial. Consider a law to make abortion illegal in the United States. Its rationale is to protect the lives of unborn babies, but this law is in conflict with the mothers' right to choose. A solution is to enforce the law less than strictly according to particular circumstances. Such a law would discourage unwanted pregnancy, but if unwanted pregnancy does occur, the right of the woman could be respected. As a second example, birth control by contraceptives was illegal in Massachusetts, but doctors made diaphragms available by placing them on a table and allowing patients to help themselves. The trouble with strict enforcement of a law is that it imposes uniform treatment on all persons, even those who hold different opinions as a matter of their freedom. Less than strict enforcement allows the coexistence of opposite viewpoints in a society. Both Catholics who opposed birth control and other citizens who favored birth control benefited from a less-than-strict enforcement of the law in Massachusetts. Two other

examples of laws for which selective enforcement may be beneficial are the law prohibiting suicide and the legalization of the death penalty. In the case of the death penalty, the governor is given the authority to make an exception to strict enforcement. Economists need to reexamine the relationship between the Western legal system and the effective functioning of a market economy. What features of the Western legal system are essential, and under what circumstances?

It is said that China is ruled by people and not by law. This statement does not necessarily imply that the Chinese system is bad. A State Department official having had dealings with the Chinese once remarked to me that "After signing a contract, the Chinese often regard the provisions in the contract as a starting point for further negotiations." Referring to a personal contractual experience Hart (1995 p. 2) remarks, "In fact, the contract is best seen as providing a suitable backdrop or starting point in the United States for such renegotiations rather than specifying the final outcome." A formal legal system does not necessarily solve the problems which the institution of informal personal relationships may be able to solve.

### III. Individual versus Collective Welfare

Individualism is an ideal in a Western market economy, as expounded by F. A. Hayek (1949). This ideal is not generally accepted in Asian countries. Individual rights may be in conflict with the common good. Economists have learned that under appropriate conditions the pursuit of individual self-interest in the marketplace can lead to efficient social output, an idea well articulated by the Chinese historian Sima Qian (see Leslie Young, 1996). In Asian societies, the common good is often considered to be more important than individual rights. Not only is individual freedom restricted, but members of a society are educated to serve the society. The society is more than a collection of individuals. Hence the welfare of the society is more than the sum of the welfares of its individual members. People in many developing countries are striving for nationalism and may consider the common good and national unity more important than individual rights.

The practice of human rights differs among countries. People in Western societies consider human rights to be violated in Singapore. China does not practice the same kind of human rights as the United States. With the consent of many, and perhaps a majority, of its citizens, the Chinese government considers a high degree of individual freedom and the practice of American-style human rights to be harmful to the common good of the country. Among other things, it makes the enforcement of law and order more difficult. Market economies have functioned with a limited amount of political freedom in mainland China, Taiwan, Singapore, and South Korea.

The welfare economics for a market economy that emphasizes the common good deserve further study. Much has been written about the welfare state in which the government provides consumption goods or redistributes income to individual citizens. The pros and cons of welfare programs have been extensively discussed. An important research topic is the modeling of government provision of education for the common good, and not simply for the private needs of individual citizens as in the case of many welfare programs. Three key questions are raised in welfare economics. First, how is a welfare function defined for an individual citizen or family, for a collection of citizens, and for a political organization? Second, how are the welfare functions of different economic and political entities in the society formed? Third, by what process do the welfare objectives of these entities affect the economic outcome in the society? When the collective good is emphasized, answers to these questions may be different from those given under an individualistic society.

Consider the determination of the education levels of the citizens for example. For a purely individualistic society, the welfare function of each citizen or family might be assumed to have its own level of education as the only argument, and the welfare function of the government may be assumed to be an aggregation of the individual welfare functions obtained by some weighting scheme. When collectivism is emphasized, the education levels of other citizens and perhaps

some aggregates of these levels also enter the welfare function of each citizen. Furthermore, the welfare function of the government may depend not only on the individual welfare functions, but on some measure of collective education. In addition, traditional welfare economics takes welfare functions as given. A collective society tends to motivate its citizens to serve the common good. The formation of welfare functions has to be explained. An American president may choose to motivate citizens to achieve a higher level of education as a national purpose. In a society emphasizing the collective good, government leadership is stronger, and its effects require more careful study. Finally, the process by which a given set of individual and government welfare functions affects the economic outcomes may differ according to the degree of individualism versus collectivism in the society. In the next section, possible differences in this process due to the institution of a one-party versus a two-party political system will be discussed.

#### IV. Multiparty versus One-Party Systems

What is the relationship between a multiparty political system and a market economy? The answer is not simple. A one-party political system is consistent with a market economy, as evident from the institutions in mainland China, Taiwan (until recently), South Korea, and Singapore, all of which practice a one-party system. Although Japan had a multiparty system, the country was ruled by the Liberal Democratic Party from 1958 to 1994. A multiparty democratic system is also not required for the practice of human rights. Human rights have been practiced in Hong Kong under British rule, but there has not been a democracy, because government officials have not been elected by the Hong Kong people until very recently, and then only to a very limited extent. Democracy in the sense of a government of the people, for the people, and by the people can be practiced under a one-party rule. Sun Yat-sen tried to form a democratic government in China under the leadership of the Nationalist Party and later asked the Communist Party to join when Soviet help was needed.

The study of the relationship between an economic system and the associated political system is an interesting topic. The development of Western countries, along with the increase in economic power of a large segment of the population, gradually led to democratic government, as the rich citizens demanded more rights to govern their own destiny. As the Chinese people become richer and more educated, they will demand more political rights from the government. Under a one-party system, political representation of the people in China through elected members of the People's Congress has been strengthened in the past decade. What forms of political institutions are likely to emerge from the current practice of a market economy in China?

Several topics concerning the relationship between a democratic government and economic behavior can be mentioned. In macroeconomics, the outcomes of elections and business cycles are interrelated, one affecting the other, as studied by Ray C. Fair (1988) and others. In political economy, Avinash Dixit and John Londregan (1996) have provided a model for the determination of the income transfers to each group of voters under a two-party system. The social-welfare function for each voter or party is a (voter- or party-specific) weighted average of the economy's deadweight loss and the population variance of consumption. A voter in each group maximizes her objective function, which is a (group-specific) weighted average of the consumption level of the group and the individual's own social welfare. Each political party maximizes its objective function, which is a (party-specific) weighted average of its vote share and its social-welfare function by choosing an income-transfer strategy that will produce a particular vector of final consumptions for all groups. The final consumption vector is determined in a Nash equilibrium as each party maximizes its objective function taking the other party's strategy as given. How is income redistribution determined under a one-party political system in which elected representatives in a congress can enact laws on tax and transfers? Possibly the above model may be relevant if the party proposes two candidates who behave like the two parties in the

model. Alternatively, one may model the economy as if the government maximizes an objective function while each group of voters can propose a final consumption schedule, as in Gene M. Grossman and Elhanan Helpman (1994), or simply vote yes or no to a government strategy, as in Grossman and Helpman (1995). The government's objective function can be similar to the objective function of the party, as in Dixit and Londregan (1996), or may include political contributions as in Grossman and Helpman (1994). There are other possibilities, depending on institutional realities.

What are the effects of democratic politics on economic growth? Some citizens in Hong Kong are concerned that introducing democratic politics might affect the current flat tax system which provides incentives for entrepreneurship. Some economists in Taiwan have stated that the recent introduction of a multiparty system has made rational government economic decision-making difficult and thus hinders economic growth. What is the statistical relationship between the rate of growth of different countries and the number of political parties or the practice of democracy? Can economic analysis shed light on this question?

In this paper I have stated a number of questions worthy of further economic research. These questions have been stimulated by the reality of recent economic development in China. China's economic institutions are evolving, but some features may be long-lasting, and the existing institutions provide ample challenges for research. In future economics textbooks, China, Russia, and Eastern European countries will appear more frequently in the index. The American economics profession is in the process of internationalization, as is the American economy itself.

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