

Understanding China's Transition to A Modern Contractual Economy

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ABSTRACT

Applying economics of institutions, this paper proposes an analytic framework for understanding China's transition from a dynastic-central planning system to a modern free market economy. The paper first examines how the contractual nature of modern free market economies is maintained through an array of institutions including free trade, private property, private enterprises, independent judiciary with judge-made law, and democratically elected government. These institutions together ensure that value-seeking is encouraged while rent-seeking discouraged in a contractual economy. Due to the difficulties of establishing these institutions from scratch, transitional economies are prone to both vibrant value-seeking and pervasive rent-seeking. While value-seeking leads to rapid economic growth and rising private income, the associated rent-seeking may lead to various social costs. The social costs would be concentrated in the form of public sector losses and liabilities due to dominant state ownership of enterprises and banks and would lead to financial crisis such as inflation and rising national debt as well as social and political crisis. The public sector losses and liabilities thus are driving the reform cycles during China's transition from plan to market. Recent intensive exposures to the Western legal and political institutions in the Greater China through international trade and investment may however break the reform cycles and eventually completing China's transformation into a modern contractual economy.

1. INTRODUCTION

Since the Second World War, East Asian countries have been going through a gradual but profound economic, political and social transformation, more or less taking the Western free market system as a model. Their successful experiences however could not be explained entirely by free market. In particular, the heavy role of the government in promoting economic growth in East Asia deviates substantively from the Western free market model and for many people effectively defines an East Asian model of economic development and growth.

This paper explores the nature of the differences between the Western free market system and the East Asian transitional economies, such as China, taking advantage of the recent advances in the new institutional economics (Coase 1988). It identifies the widely existing non-contractual relations among individuals, firms, and the State as a fundamental feature of the transitional economies and examines its various implications.

The non-contractual relations seem rooted as much as in the post-war central planning experiments as in the ancient dynastic tradition (Huang 1990 and Fairbank 1992). The recent transition in East Asia could be seen broadly as part of the long evolution from a dynastic system to a free market system. Using China as example, the paper provides a simple but systematic framework for understanding the transition economies.

2. THE CONTRACTUAL NATURE OF A MARKET ECONOMY

The Western free market model is abstracted from the experiences in the Western Europe and United States. Its foundation includes an economic system of free market and private enterprise, a legal system of independent judiciary (especially the common law or judge-made law), and a political system of democratically elected government.

One key feature of the free market model is its contractual nature: individuals, firms, and even the State are allowed to exchange and produce goods and services voluntarily through mutually beneficial contracts or contractual relations. The coercive forces monopolised by the State are used mainly to protect private property, to enforce voluntary exchange and production and to levy taxes for the purposes of providing public goods.

Why is voluntary exchange or contractual relations so important for economic development and growth? To answer this question, it is useful to review the basic results of price theory using the familiar demand and supply curves as shown in Figure 1. The producers and consumers sell and buy products voluntarily given the market price and the government tax. Due to the voluntary nature of the exchange, the consumer surplus and producer surplus must be greater than zero even after paying taxes and any other transaction costs. If they could not gain anything from the exchange, they would have the option of not entering the market. The costs of taxes, transaction costs, and even the so called ‘dead weight losses’ would all be taken into account by the market participants. As long as the consumers and producers voluntarily enter the market, the total benefits from the trade must be more than the total costs of the trade to the market participants. The gains from voluntary exchange and production are the engine for the accumulation of private and national wealth and for economic development and growth.

In Figure 2, the gains from voluntary trade are illustrated as a move from point I to II where U_1 and U_2 represent utilities of individual 1 and 2 respectively, who are engaged in a voluntary exchange or any contractual relations.² The move is clearly a ‘Pareto Improvement’.

In Figure 3, a move from point I to III is clearly not a ‘Pareto Improvement’. Individual 1 gains at the cost of individual 2. Point III would not result from a voluntary or contractual relations between the two individuals. There is clearly an element of coercive redistribution in the move from point I to III. What would happen if individual 1 has to compensate the losses of individual 2 after arriving at point III?

Figure 4 shows a possibility where individual 1’s utility drops below his initial level at point I, after compensating for the losses of individual 2 (a move from III to IV). Let’s call activities leading to this kind of results (I-III-IV) rent-seeking: activities that brings a small private gain at a large cost of others or the public. According to this definition, rent-seeking would not be initiated when there exists an effective mechanism, such as an independent and fair judiciary, for compensating the losers.³

Figure 5 shows another possibility where individual 1’s utility still increases above his initial level at point I after compensating for the losses of individual 2 (a move from III to V). Let’s call activities leading to this kind of results (I-III-V and I-II) value-seeking: activities that brings a net private benefit after deducting all the costs to others and the public. When the mechanism for compensating the losers exists, the movement from point I to III and then to V could also be regarded as voluntary or contractual in nature similar to the move from point I to II as shown in Figure 2. Examples of the move from point I to III and then to V are common in market economies, such as in those legal cases involving product liabilities. The court usually would order the manufacturer to pay the damages to consumers caused by its defect products. In most cases, the manufacturer can still make profits after paying the product liabilities.

What is the sufficient conditions to ensure value-seeking activities and contractual nature of the economy? Ronald H. Coase (1988) answered this question by pointing out that when transaction costs are zero, the exchange and production activities by individuals and firms would have no positive or negative effects on the other parties (or no externalities or no social costs or no inefficiency).

Moreover, when transaction costs are zero, competition among individuals and firms would be based purely on price. According to Adam Smith’s invisible hand theory, the price of a competitive market would lead individuals and firms to an efficient allocation of resources (e.g. a Pareto optimum where no change would benefit anyone without hurting another).

Hence, zero transaction costs would ensure value-seeking and contractual nature of the economy and eliminate rent-seeking. Zero transaction costs are assumed in the neo-classical economic model of free market.

However, in the real world, transaction costs are high due to imperfect, asymmetric, and uncertain information about the delineation and enforcement of property rights, contracts, markets, and technology. Would the high transaction costs in the real world invalidate the value-seeking and contractual nature of the Western free market economies?

Ronald H. Coase (1988) does not answer this question directly but has pioneered the research that leads to clear answers to the question. He points out that when transaction costs for an ‘arm’s length’ relation are high, the relation would be managed within a firm by playing a ‘repeated game’ among owners, managers, and workers. Hence, the costs of exchange in the market and the costs of management in the firm would determine the boundary between the market and the firm.

Economists of the property rights school (Alchian and Demsetz 1972 and S. N. S. Cheung 1983) answered the above question clearly by showing that the relations among the owners, managers, workers, suppliers, customers, bankers, and other stakeholders in the private firm are as contractual as that between the buyer and the seller of the grocery in the market. All of them exchange voluntarily what they own privately for what they get from the firm. The workers exchange their labour services for a wage. The managers exchange their managerial talents for a salary. The owners exchange their capital for the residual profits. The contractual nature of the firm would render the boundary between the market and the firm irrelevant for efficient allocation of resources. ‘The firm is dead; long live the firm’ conclude Armen A. Alchian and Susan Woodward (1987). Contractual relations would minimise total costs which includes transaction costs as well as management costs. In particular, an efficient allocation of resources does not require zero transaction costs (Demsetz 1988). The contractual nature of the firm implies that the competitive markets and private enterprises would still lead to an efficient resource allocation even when transaction costs are not zero. Zero transaction costs, although a sufficient condition, are not necessary conditions for the efficiency and contractual nature of free market.

The elegant extension of the contractual nature and efficiency results from competitive market to private business firm by the property rights economists could not be over-emphasised but nevertheless is not complete. The contractual theory of the firm has laid the theoretical foundation for the institutions of modern corporation, modern finance, and modern markets for labour, managers, capital, and technology. However, due to information problems, contracts and private property rights are usually imperfectly and incompletely defined even in the Western market economies. Actual and potential shirking and opportunistic behaviour within the firm and among the contracting parties may lead to serious inefficiency even in the market economies with widely spread private property rights. Hence, Economic Institutions of Capitalism by Oliver Williamson (1985) and Wither Socialism by Joseph Stiglitz (1994) give not as rosy and clear-cut a picture of the Western free market as the invisible hand or contractual theories of the market and the firm would suggest. They emphasise many problems of using markets and contracts due to imperfect information.

Would the general imperfection and incompleteness of property rights and contracts invalidate the contractual nature and efficiency of the Western free market model? Recent studies in law and economics give answers to this question by showing that an efficiency-promoting legal system such as the English common law or judge-made law would provide a lower cost mechanism to ex post fine tune private property rights and contractual claims and obligations than the alternative of defining ex ante perfect and complete property rights and contracts. They have found that on average the judge-made law in the Western countries tends systematically to produce efficiency-promoting results (or Pareto improvements) instead of wealth redistribution (Wein 1995 and Glendon etc. 1982). As shown in Figure 6, the path characterising the results of economic activities over time for two typical individuals

would follow the direction of Pareto improvement under a common law system. Hence, an efficiency-promoting legal system greatly reduces the potential inefficiency of the market caused by imperfect information.

It should be noted that the efficiency of the legal system lies in its effectiveness in encouraging value-seeking and discouraging rent-seeking. This would require the legal system to transform effectively results in point III into those in point IV or V as shown in Figure 4 and 5 (e.g. rewarding value-seekers but compensating the involuntary losers). The common law system has been effective in achieving these tasks. However, the common law principles, which are behind the case laws, have also been absorbed by other legal traditions, such as the civil law tradition. The most common example is the company law. Regardless legal traditions, company laws in all countries seems to have facilitated contractual relations among the owners and various stakeholders of the company.

A system consisting of free market, private enterprise, and judge-made law is still an incomplete system. Who would protect and enforce ultimately the independent judiciary, the private property rights, and the free market? The political power which is capable of the above tasks may also be able to redistribute wealth and destroy all the contractual relations under the free market, free enterprise, and judge-made law. Society needs politically based law and government to collect taxes, help the poor, and maintain social order but may also want to limit the power of the government.

According to the social contract theory, this is achieved in the West through a constitutional agreement on the separation of power between an independent judiciary and a democratically elected government which includes a statutory law-making body of the Congress and an executive branch led by the President. Hence, the independent judiciary would maintain a minimum level of efficiency-promoting incentives or a stable contractual relations while the democratically elected President and Congress with limited terms would take care of the necessary redistribution of wealth and the maintenance of basic social order (Morrison 1996 and Werin 1995).

Our discussion about the contractual foundation of the Western system would miss an important element without including the costs of establishing and maintaining the system. The transaction costs of the market, the management costs of the firm, the litigation costs of the law, the administration costs of the government, and the election costs of the democracy all consume real resources. Also, the marginal cost of maintaining the current system and the fixed cost of establishing it should be distinguished. The marginal cost of maintaining the legal system based on the judge-made law and the democratically elected government seems substantial and may be higher than that of running an authoritarian centrally planned system in the short-run. The tax revenue as percentage of GDP is much higher in the United States (about 40%) than in China (about 15%).

As we study the transition of China from a dynastic-central planning system to a free market system, the one-time fixed cost of destroying the old and building the new systems is as relevant as the marginal cost of running each of the alternative systems. When examining the fixed cost, we are forced to look at the “sunk” cost paid by each society in their long search for a better life since hardly any cost is really sunk in terms of shaping the social-political-economic culture of a society. Although learning may reduce substantially the fixed

cost of establishing a free market system, the factors of history and culture have to be brought into any meaningful discussions on the transition from dynasty or plan to free market.

3. THE NON-CONTRACTUAL NATURE OF TRANSITIONAL ECONOMIES

The discussions in the previous section on the contractual nature of free market provide us with a useful benchmark to study the non-contractual nature of transitional economies. In this and the next sections, the key features of transitional economies are examined using Chart 1 as an illustrative framework. Chart 1 highlights the key elements of the two alternative economic systems and the key transitional problems.

A dynastic or centrally planned system usually do not have a democratically elected government nor a legal system of independent judiciary. Contractual relations among individuals, enterprises and the emperor or central planner are either absent or weak. The planner or emperor would play the role of the ‘visible hand’, the judge, the re-distributor, as well as the protector. The question of transition from dynastic-central planning to free market is how to unravelling the existing non-contractual relations and to establish new contractual relations.

In China, gradual reform since 1978 has attempted to build partial contractual relations on a subset of economic activities. During this period, a large amount of activities, especially in the state sector, were still carried out on the base of non-contractual arrangements laid down during the central planning period.

Privatisation in Russia and Eastern Europe has attempted to re-establish private property rights and rebuild a complete set of contractual relations. However, even if formal contractual arrangements could be set up quickly through institutional reforms such as privatisation, the existence of the deeply rooted informal institutions (North 1990) would lead, in practice, to incompleteness and truncation of the formal property rights and contractual relations. Also, in the short-run, it is virtually impossible to establish an efficiency-promoting legal system based on the judge-made case law to fine tune the incompleteness and truncation of property rights and contracts. Moreover, the young democratically elected government needs time and luck to establish basic social order with minimum coercive forces. Political stability is essential for any lasting contractual relations.

Hence, contractual as well as non-contractual relations usually co-exist in the transitional economies under either gradual reform or radical reform. The non-contractual relations in the transitional economies usually are governed by the restrictions imposed by both the government and the history on delineation and enforcement of property rights and contracts. These restrictions inevitably create high costs of establishing full contractual relations. It seems better to call the situation here truncation of property rights and contracts to distinguish it from the normal incompleteness at margin of property rights and contracts found in a mature market economy.

The incompleteness of property rights and contracts in mature market economies is a result of voluntary choices by private property owners and contractors among the alternatives of specifying ex ante property rights and contracts in complete detail or of fine-tuning them ex post through the legal system. Hence, while incompleteness of property rights and contracts

may be found in both the market economies and the transitional economies, the truncation of property rights and contracts is likely to be pervasive in the transition economies.

As a result of truncated property rights and contracts, transitional economies do not have a full range of competitive markets nor an effective legal system which would ex post reward value-seekers, punish rent-seekers, and compensate involuntary losers. So, both value-seeking and rent-seeking would prevail in transitional economies.

Conceptually, the activities and consequences of rent-seeking are distinguishable from those of value-seeking as shown in Figure 2, 4 and 5. In reality, especially at the micro level, an activity or project may involve both value-seeking and rent-seeking elements that are costly for outsiders, such as the government, to identify and distinguish from each others.

Both the value-seekers and rent-seekers are simply looking for pecuniary and non-pecuniary benefits. While value-seeking may be present in both competitive market economies and transitional economies, rent-seeking is likely to be much more pervasive in the transitional economies than in market economies. In addition to an efficiency-promoting legal system, the system of private property in the market economies implies that the losers with private property facing with rent-seeking would defend themselves forcefully against the rent-seekers. In the transitional economies, the losses from rent-seeking are usually assumed by the State due to extensive state ownership of property. The State's massive losses from rent-seeking would then threaten the stability of the whole economic system by generating crisis of inflation, rising national debt, and bankruptcy of state enterprises and banks. Hence, the system-wide rent-seeking behaviour and the associated systematic risks due to massive losses in the state sector in the transitional economies differ qualitatively from localised and isolated rent-seeking phenomenon in the mature market economies.

Markets in the transitional economies facilitate both value-seeking and rent-seeking and amplifies both the social benefits of value-seeking and the social costs of rent-seeking. On the other hand, many transactions in the markets tend to reduce the degree of truncation to property rights and transform them into private property rights.

Value-seeking increases the wealth of individuals and enterprises as shown in Figure 2 and 5. It also creates many social benefits which are usually ignored or under-appreciated in standard economic analysis. One key social benefit of value-seeking is the expansion of the tax base as economies grow. In the traditional economic analysis, taxation is regarded as a distortion to an ideal free market economy without taxes. But, in our analysis as shown in Figure 1, taxes are one of many costs of doing business paid voluntarily by individuals and firms. The tax revenues are social benefits in addition to private benefits from voluntary trade.

The market prices generated by value-seeking are also important information for efficient use of decentralized knowledge (Hayek 1945). The social value of market price information is especially precious in the transitional economies since the alternative centrally set prices usually would lead to highly inefficient resource allocations.

The experiences from value-seeking activities by citizens in the transitional economies provide in-the-market training as well as set educational examples for others on the working of the markets. Such human capital developed in the transitional economies is also a previous social benefits of value-seeking.

These and other social benefits of value-seeking are regarded as important factors for economic growth, as pointed out by the World Bank (1994) study *The East Asian Miracle*. These social benefits and resulting boost to economic growth may lead one way or another to rises in the future streams of government tax revenues. The present value of them can be seen as a key component of public sector assets. Another category of public sector assets in the transitional economies is the consolidated assets of the state enterprises and state banks.

The social costs of rent-seeking are well known. One example of the costs is the waste of over-investment under the artificially low and even negative real interest rate on the state bank loans in China, including the waste of efforts on lobbying the state bank officials by the non-state enterprises. The costs of over-investment would eventually turn into losses in the state enterprises and banks.

Some of the irrational behaviour and harmful effects of China's rural township and village industrial enterprises, such as pollution and irrational location of industrial enterprises, can also be seen as costs of rent-seeking due to the insistence on collective ownership of rural land by the government.

These social costs of rent-seeking could become barriers to sustained economic growth of the transitional economies. The costs would eventually turn into a rise in future government expenditures. The present value of them forms a part of the public sector liabilities. The public sector liabilities also include all the explicit and implicit financial commitments by the government in the past and at the present but due in the future. Hence, they would include all deposits in the state banks, pension to state employees, and government expenditures on military, education, social welfare, and administration.

To understand the working of the transitional economies, we need to explore the implications of social benefits from value-seeking and social costs of rent-seeking. In accounting terms, the social benefits and costs can be examined in the form of a balance sheet of public sector assets and liabilities.

4. REFORM: BREAKING DYNASTIC-CENTRAL PLANNING CYCLES

Well defined and enforced private property rights would lead to contractual relations with little social costs while truncated property rights limit contractual relations and bring about additional social costs. What are the forces behind the evolution of private property rights and truncated property rights? This section examines first the spontaneous formation of property rights by private initiatives and then the role of the government in the establishment of property rights regime.

According to Harold Demsetz (1967), private property rights over un-owned resources are likely to emerge spontaneously when their market value exceeds the costs of delineating, negotiating, enforcing, and protecting the newly established private property rights. The spontaneous formation of private property rights in a free market economy is simply one kind of value-seeking activities which do not bring about significant social costs. This could happen in the transitional economies as well. However, the spontaneous formation of truncated property rights accompanied with severe social costs from rent-seeking is likely to be the case in a transitional economy.

The opening to foreign trade and investment allows a transitional economy to realise its comparative advantage and increases the value of those resources whose property rights are previously not well defined under the closed economy. Increases in domestic trade also have similar effects. The expected rise in the market value of the un-owned or publicly owned resources would encourage private initiatives to establish private property rights, or truncated property rights when the former are too costly to secure during the transitional period.

Costs of establishing new property rights and changing the existing truncated property rights include those of producing and implementing private initiatives, assessing future value of the resources, negotiating necessary wealth redistribution, and enforcing the new contractual arrangements. An example of spontaneous formation of truncated property rights is the rapid growth of rural township and village industrial enterprises in China which are neither private nor state-owned. The initiatives to establish and expand the rural industrial enterprises came from the local communities usually led by the entrepreneurial cadres from the township governments. The rural enterprises usually produces labour-intensive products and exports a significant part of their output. As discussed earlier, rural enterprises also created pollution and other wastes such as over-investment and inefficient use of energy and land.

A regime of truncated property rights should be more efficient than the pure central planing system, which simply prohibits efficiency-promoting contractual relations and eliminates both value-seeking and rent-seeking activities. It would also do better than the commons with free entry, where all rents would be dissipated. Under the truncated property rights, the non-contractual arrangements governed by government interventions would provide at least a platform for an orderly, if not very efficient, rent-seeking activities. On the other hand, the newly introduced partial contractual arrangements would give some incentives, however distorted, for value-seeking.

If ignoring the marginal and fixed costs of the efficiency-promoting legal and political systems, the regime of truncated property rights is clearly less efficient than the free market system. However, in reality, the costs of the Western style legal and political systems are real and substantial. Hence, it is too quick to claim that the Western free market system would be necessarily superior to that of the truncated property rights during the transitional period.

Given the above rationales for the existence of the truncated property rights system in the transitional economies, it seems useful to examine its systematic features. The core issue here is the contents of government policies, which would determine the extent and consequences of rent-seeking.

How does the government make policies? What are the decisive factors influencing the decision-making of the government? The government may behaviour like a benevolent dictator trying to maximise a social welfare function, however that function is defined. The government may also represent different interest groups for different policy issues. It may also simply response passively and pragmatically to the existing problems in the society. The government may also have its own agenda such as internal power struggles which could be quite independent from the issue of economic development and growth.

In the following analysis on the reform cycles, it is assumed that the government is a black-box which produces new policies in response to current and potential economic,

political and social crisis. It does not matter how the policies are decided and whether they are good or bad. What is important here is the fact that any new policies would first change the structure of the truncated property rights either directly through the government interventions or indirectly through the private sector responses to the new policies. The change in the structure of truncated property rights would then affect the matrix of social costs and benefits and change the balance or imbalance of public sector assets and liabilities. We identify this public sector asset-liability imbalance or the gap between assets and liabilities as the sources of current and potential economic, political and social crisis.

Reform cycles, from institutional change to public sector asset-liability imbalance and then to institutional change again, are driven by fluctuations in the social costs and benefits from value-seeking and rent-seeking activities under a regime of truncated property rights.

For a typical private firm in the Western free market economies, assets and liabilities (liabilities here include both debts and owners' equity on the right hand side of the standard balance sheet) are always balanced in book value as well as in market value. When the market value of its assets could not meet its liabilities due to losses, the firm has to go bankrupt. However, even when it is going through a legal procedure for bankruptcy, the rescheduled liabilities would have to be equal to the market value of its assets. Hence, any losses of the firm would have to be absorbed by its equity owners, creditors and stakeholders. The business cycles in the free market system do not change much the fundamental balance of asset-liability at the firm level. The risks of business fluctuation are diversified and absorbed at the basic units of households and firms without serious consequences to the asset-liability balance of the public sector.

In many ways, the public sector is like a giant firm. A crucial difference between a private firm and the public sector is that when the market value of the public sector assets can not meet its liabilities due to public sector losses or excessive government expenditures, it does not have to go bankrupt unless the government is overthrown. Hence, any losses in the public sector have to be accumulated as liabilities until they are paid out by new assets generated in the future. There is little chance for the public sector to escape from its liabilities without leading to serious political consequences.

Printing money would generate inflation. Borrowing heavily would lead to debt crisis. Refusing to pay promised social welfare, wages and salaries, and other expenses would certainly threaten the survival of the government. Fortunately for the government, its inescapable responsibilities are matched by its unique privilege relative to a private corporation. The government usually would not go bankrupt but a private corporation has to when the assets are short of meeting the liabilities.

The gap between the market value of the public sector assets and its liabilities is the public sector asset deficit or the public sector asset-liability imbalance.

The part of the asset deficit that is hidden under the balance sheet would not need immediate financing. However, when the hidden asset deficit is revealed, for example when the pension to retired public sector employees is due, the revealed part of the asset deficit would be transformed into the current deficit, which is defined as the consolidated budget deficit of the public sector including the state enterprises, state banks, and the state budget. The consolidated budget deficit has to be financed immediately usually by printing money or borrowing domestically or externally.

An alternative to the financing of current deficit is to sell the assets of the state-owned enterprises. The asset sales would privatise the enterprises and generate some current revenues but may not reduce (probably will increase) the asset deficit since the private sector would only buy net assets of positive market value not net liabilities of negative market value. The private investor would pay for valuable land but not for the responsibility for pension and unemployment benefits of the state enterprise employees.

Hence, the asset sales may just postpone the asset-liability imbalance but not eliminate this stock problem. However, the privatisation could in principle reduce future deficits by getting rid of state-owned enterprises and thus solve the flow problem.

Is there any reform strategy which would solve both the flow and stock problem of public sector asset-liability imbalance? If there is any, the reform has to increase the market value of the public sector assets without increase its liabilities. It has to create a capital gain for the public sector. One way for the government to create and realise a significant part of a capital gain is for it to diversify dramatically the state ownership of enterprise assets. At present, the State usually own 100% of the assets in a state-owned enterprise. Diversification means that the State should own less than 50% of any particular state-owned enterprise, perhaps only 10%. The State could in principle sell 90% of a state-owned enterprise and invest the privatisation revenue in nine private firms, perhaps holding 10% shares of each of the nine private firms. In principle, this diversification operation would not require a reduction in the market value of total state-owned assets.

One the other hand, if the diversification operation reduces the state-owned shares in each newly restructured enterprise to 10% or less than 30%, for example, the incentives at the restructured enterprises would be very different from those of 100% state-owned enterprises. The asset value of the restructured enterprise is likely to appreciate due to improved monitoring by private shareholders who hold 90% or 70% of the firm's shares. The government would then be able to share this capital gain through its diversified ownership of minority shares in the restructured enterprise as well as other private firms (see Sheng and Xiao 1995 for detail).

The above diversification approach to reforms of the state-owned enterprises in the transition economies, although looks plausible and appealing to the government policy-makers and academics, has overlooked a point which is emphasised in this paper: the non-contractual nature of the transitional economies. The restructuring proposal here and many other more complicated proposals are unquestionably contractual in essence. It could be implemented easily in a free market economy. In fact, sales of state-owned firms have been carried out just as outlined above in the market economies.

The non-contractual nature of the transitional economies implies that the above proposed reform would eliminate the rent-seeking opportunities for managers, workers, and government officials associated with those state-owned enterprises. They are likely to reject this contractual solution.

Due to the difficulties of implementing thorough reform, the transitional economies are prone to growing public sector asset deficit which would generate sooner or later a crisis of inflation and rising national debts. The public sector financial crisis would increase system risks of the transition economies. Clearly, private property system tends to spread the risks of asset losses among individual asset owners while the state ownership system is likely to

concentrate asset losses in the public sector and then turn financial crisis into political and social crisis.

The experiences of the transitional economies are relatively short compared to the long history of China's dynasties. But, the reform cycles of the transitional economies could also be seen as a modern time extension of the dynastic cycles which have been lasting for thousands of years in China. The relatively stable free market system has emerged in the Western Europe and the United States only a few hundred years ago. In retrospect, China's transition from dynasty to free market would have to be a long and difficult process since the pre-conditions for a modern contractual economy such as the efficiency-promoting legal system and the democratically elected government are quite restrictive and expensive (just think about the lawyers and the election campaign in the West). The 'European Miracle', as explained by E. L. Jones (1987), has a lot to do with the natural environments and early political circumstances in European history. In particular, a geographically, historically and politically fragment Europe with many rival nation-states may be one of the key explanations for emergence of the capitalism and modern contractual economies there. China's long dynastic history is filled with strong and united central government.

Douglas North (1990) pointed out that nations with similar initial conditions have historically taken very different paths of economic development and growth. Due to the differences in their selection of institutions, some nations may fall into development trap while others grow rapidly.

In our analytic context, once trapped into the dynastic or reform cycles, it is not easy for the society to break the cycles and unravel the non-contractual relations rooted in the dynastic or central planning traditions. The fixed cost of destroying the non-contractual relations and rebuilding the contractual relations from the collapse of dynasties may be prohibitively high. Historians working on China such as Mark Elvin (1973) has argued that industrialisation and industrial revolution did not happen in China because China's high man-land ratio around 1500s, which was a result of its superior development in traditional farm and industry, left with little surplus for it to initiate industrial revolution. Today, the point made by Mark Elvin seems still valid in terms of the lack of enough surplus to pay for the one-time fixed costs of building a modern contractual economy. The per capita income level in China is still very low and will remain low in the next century even if China can maintain a high rate of economic growth. According to the path dependence theory, we should not hold too great expectation on China's transition to a modern contractual economy.

However, an alternative perspective based on the evolution theory (Alchian 1950) may also be relevant. In the above model of reform cycles, the government may not intentionally minimise the public sector asset deficit. But, as long as unsustainable public sector losses are threatening the survival of the government, changes in the policies would happen. The changes in government policies may or may not improve the situation of the public sector asset deficit. Nevertheless, as long as the government is able to survive again and again the crisis of public sector losses, there may be a probability that the surviving government would eventually adopt the resilient and relatively stable free market system based on contractual relations.

This evolutionary perspective may become more and more relevant as the nations in the world are no longer isolated and increasingly competing with each other in the world

markets. The modern technology of mass production, computers, tele-communication, long-distance transportation, etc. have reduced dramatically the costs of getting information about the advantages and disadvantages of various economic systems. The East Asian city-states have been the fast learners in this regard partly because they are much easier to be integrated into the capitalist world economy than the giant dynastic-central planning Chinese economy. These small open economies have to rely on the world market for their economic development and growth. Transforming China from a dynastic-central planning system to free market is certainly more challenging. But the task seems much more manageable now than any time in the past, thanks to the East Asian examples of successful economic development and growth.

5. RECENT REFORM CYCLES IN CHINA

From the last Chinese emperor to the Nationalist Party leader in Taiwan and the Communist Party leader Mao in mainland, China has gone a long way in breaking up the ancient dynastic system. The successful establishment of the People's Republic of China in 1949 was clearly a response to the long crisis of the decay of the Qing Dynasty and of the threat of foreign imperialists. However, the young Republic rejected the Western free market model at the start and carried out thirty years of experiments in a central planning system. The market-oriented reform started only recently in late 1970s when Mao died and his Culture Revolution brought about an economic, social and political crisis of how to feed one billion people. The response to the crisis by the Chinese reformer Deng Xiaoping was to reverse the agriculture collectivisation by contracting farm land to peasant households. The new household contract responsibility system was surprisingly successful. After the de-collectivisation, rural farm and non-farm output increased dramatically and so did the rural income.

The industrial reform in China was also prompted by a fiscal crisis in the early 1980s. Worried about the declining revenues from the state-owned enterprises, the government started to make contracts with the enterprises on a few key dimensions of industrial production: output, profits, and management autonomy. The results of the industrial contract responsibility system were quite mixed. Industrial growth was high not much due to the improved incentives in the state-owned enterprises but largely because of the rapid growth of rural township and village industrial enterprises which employ cheap peasant workers and free land to manufacture simple products for domestic as well as international markets. The state-owned enterprises were heavily subsidised by the state banking system. The rapid expansion of state bank credit led to rising inflation, inter-firm debts and national debts.

Inflation and public concerns about corruption led to the tragic event of June 4th 1989 when the government had to use armed forces to suppress student demonstration in Beijing. The event of June 4th was not unique in China's history except the massive reporting by the international media. The June 4th event almost brought China back into economic stagnation and international isolation during 1990-1991. Deng Xiaoping responded to the new crisis by further opening the economy to foreign trade and investment and by speeding up economic liberalisation. As a result, the economy started to grow rapidly after 1992. The non-state enterprises, including the foreign invested joint-ventures, became the engine of growth after 1992.

However, by 1994, the Chinese economy became more and more like a typical system of truncated property rights. Both value-seeking and rent-seeking are pervasive. The resulting high economic growth and huge social costs as reflected in rising inflation and inter-firm debts are dramatic. Actual and potential inflation crisis has led the government to initiate a tight austerity program since 1993. Other reforms in the financial sector and state-owned enterprises also followed but the government stopped short of comprehensive privatisation of the state-owned enterprises. These latest reforms, although quite useful in stabilising the macro economy in the short-run, have not solved the difficult problem of pervasive rent-seeking and inefficiency in the state-owned enterprises and banks.

6. WILL CHINA TURN FREE MARKET?

While China seems moving fast in recent years towards free market economic institutions it is still far from clear that the Chinese people would choose to establish the Western style legal and political systems in the near future. It remains to be seen how firm and stable contractual relations could be built without the Western style legal and political systems. It is a question not only for China but also for the rest of the world. Should the non-contractual economies such as China become a member of the contractual multi-lateral organisations such as the World Trade Organisation (WTO)? Excluding China from WTO would certainly hinder China's transition to a modern contractual economy. That would be a failure and a loss to the free market world economy. On the other hand, including China into WTO also poses fresh challenges to the free market world economy.

The experiences from Japan and other East Asian economies are relevant for China's reform but not decisive. Institutional reforms during the Meiji Restoration brought Japan more than half a century experiences of free markets and free enterprises before the World War II with no Western style legal and political system. The World War II brought about a brief period of central planning and military expansion for Japan. But Japan's loss of the war allowed the US Occupation to set post-war economic development policies that are consistent with the Western free market model, including the elements of efficiency-promoting legal system and democratically elected government. Japan's successful economic growth after the war has been based on both private enterprise and responsible government and workers. The responsible government and workers have more than compensated the relatively weak Western style legal and political systems in Japan by building explicit and more often implicit contractual relations. However, the recent asset bubbles and the resulting bad loans in Japan's banking system shows the potential troubles with the implicit contractual relations in the Japanese system.

Korea, Singapore, and Taiwan have been following the general development strategies of Japan very closely. The case of Hong Kong is somewhat different since all the essential elements of the free market institutions have been imposed and enforced in this British colony for almost 100 years now.

While the experiences of responsible government in Japan and the other East Asian economies are useful, they are nothing new to China. Markets had flourished and died in the history of China, together with the dynasties. China had good and bad emperors as well as good and bad judges but the emperors and the judges were never separated. The competition in the international markets is better able to make governments responsible in

Japan and other small East Asian countries than in a country as large and as ancient as China. China would have to rely heavily on its own search for the best ways towards modern economic growth and development.

The Western legal and political systems are new to China and deserve serious study and consideration. However, the Savings and Loans scandal, the drug and gun industries, and the rising burden of government expenditures on social welfare programs in the United States are some of the examples which reduce the appeal of the Western free market model and blur the difference between the East and the West.

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² Figures 2 to 6 are adopted from Werin 1995 where similar figures are used to illustrate the concept of Pareto efficiency. Here we are trying to illustrate the concepts of value-seeking and rent-seeking.

³ This definition of rent-seeking focuses on results, instead of the nature of activities, and is a little different from the original definition of rent-seeking provided by Buchanan and Tullock (1980). They attempted to define rent-seeking by the nature of activities (e.g. whether they are wasteful or not). The definition here using results as a reference is conceptually clear and easy to grasp. Empirically, it is difficult to tell whether an activity is wasteful or not but it is possible to examine the results of an activity in terms of gains and losses.

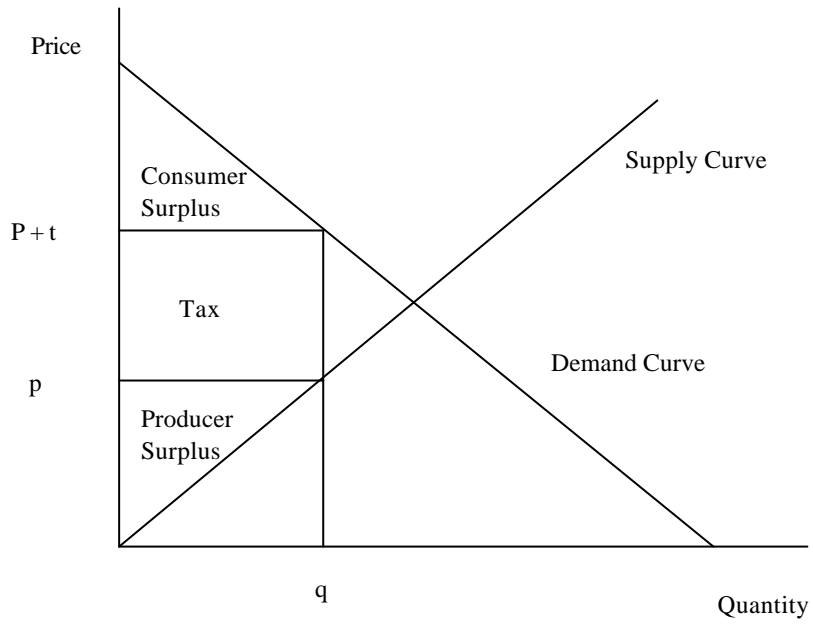


Figure 1. Gains from Voluntary Trade

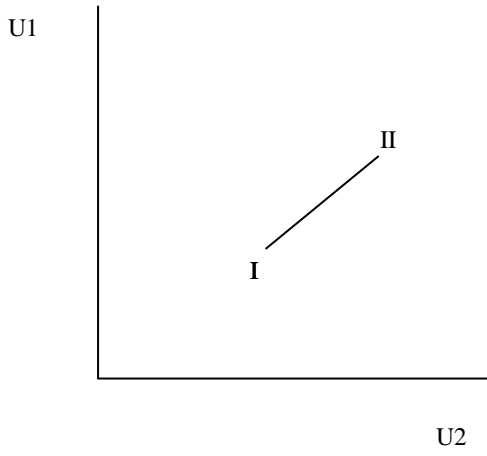


Figure 2.

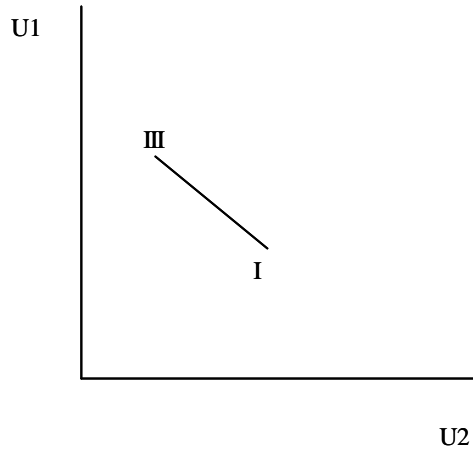


Figure 3.

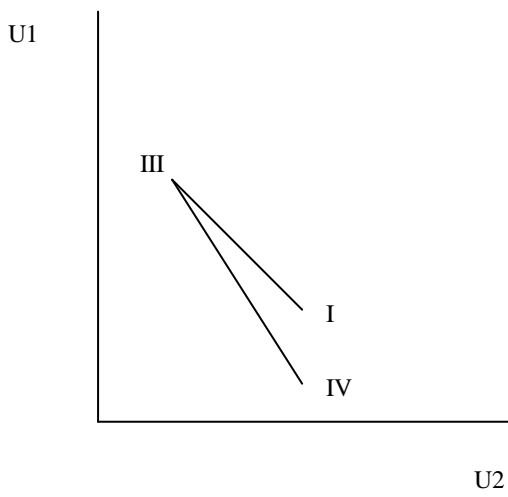


Figure 4.

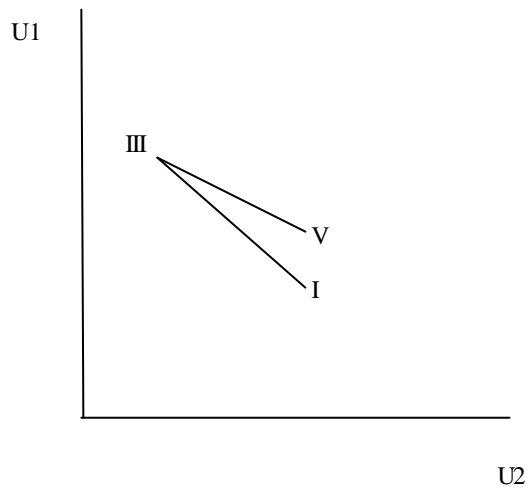


Figure 5.

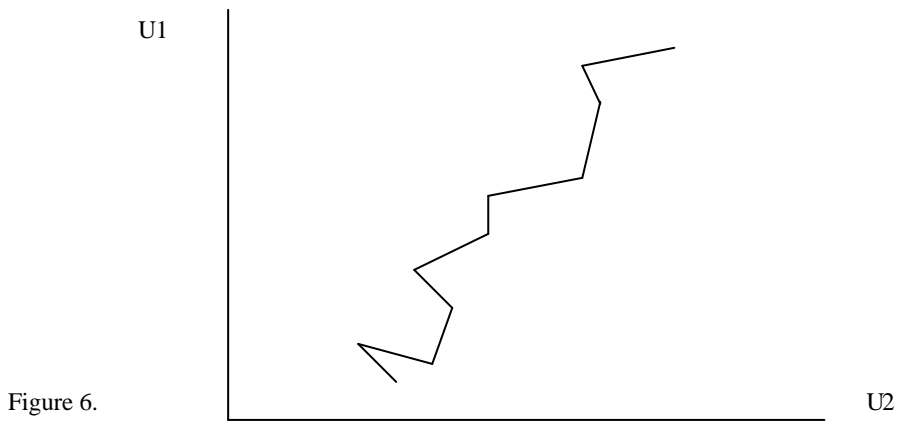


Figure 6.

Chart 1. Reforms in the Transitional Economies: Breaking the Dynasty Cycles?

