**Abstract**

After Mao’s death, when members of the elite were able to travel abroad, they concluded that they had gotten something terribly wrong. Socialism was the best economic system, but their implementation had left China desperately poor. In trying to solve that puzzle, they got one crucial thing right–facts trump theories. The way to fix socialism was to experiment with many different approaches.The result was a series of reforms mostly unplanned, in some cases illegal, but tolerated because they worked. Their success eventually convinced the leadership to shift to an economic model controlled primarily through the market.

**A Very Coasian Revolution**

“Practice is the only Criterion for testing truth.”

(*Theoretical Trends*, 1978)[[1]](#footnote-1)

The final project of Ronald Coase’s long life was a book on China’s transition from socialism to a market economy, coauthored with Ning Wang. There were several features of China’s transition that made it of special interest to Coase. The first was that, as he interpreted the events, Mao’s successors succeeded by following a strategy for reforming their economy, trial and error with feedback from real world observation, that Coase had long recommended to his fellow economists for the reformation of economics. Another was that, by doing so, they produced data for the latter project. When, in an interview with his co-author,[[2]](#footnote-2) Coase suggested that “If the right kind of economics that I have in mind is first developed in China, it will be rightly called the Chinese school of economics by future historians,” he was not merely being polite. A final reason was that the success of Chinese reform supported Coase’s view of how economic policy ought to be developed–by trying many approaches to see which worked.

In Part I, I sketch the account Coase and Wang offer of how China went capitalist. In part II, I offer two reasons why those events were of particular interest to Coase. In part III, I explore the question of whether the account offered by Coase and Wang is correct or whether Deng Xiaoping succeeded in pulling off the largest and most beneficial con job in history and Ronald Coase fell for it. In part IV I argue that Coase was correct in preferring the trial and error approach followed by Deng and his successors to any deliberately planned reform.

**Part I: How China Became Capitalist**

Under Mao Zedong, China was ruled by a communist party. Its official ideology was socialism. The economy was for the most part state run. Prices, insofar as they existed, were set by the state, land collectively owned and farmed.

Mao died in 1976. China is still run by a communist party. The official ideology is still socialism. Mao is still a revered figure. China’s economy, however, is not strikingly more socialist than that of the U.S. or the nations of western Europe. Prices for most goods and services are market prices. Control over land use, while not private *de jure*, is, to a considerable extent, private *de facto*.

Between then and 2010, per capita GDP increased roughly twenty fold. Judged by the magnitude of the change and the number of people affected, it is arguably the most rapid increase in human welfare that has ever occurred. *How China became Capitalist* is the story of how it happened.

# Decentralization Done Wrong

A central feature of Mao’s rule, largely missed by foreign observers, was that Mao, unlike Stalin, believed in decentralization.[[3]](#footnote-3) For most of the civil war the communist forces consisted of multiple armies separated by hostile territory hence effectively independent. Decentralization was, on the whole, incentive compatible, since the survival of each of the independent communist forces depended on its military success.

Once the war was over the Chinese economy, like all economies, faced the coordination problem. It needed some way of making sure that enough coal and iron ore were mined to feed its iron and steel industry, enough iron and steel of the right sorts produced to make the trucks and trains and rails for the transport industry, the guns and tanks for the military, enough grain and rice grown to feed the population, including the workers mining coal and ore, building trucks and locomotives and tanks, enough trucks and locomotives produced to move that food and coal and ore to where it was needed. The centralized solution to that problem, central planning and control, works badly on the scale of a national economy, as demonstrated by the Soviet Union. The decentralized alternative scales much better–provided that it has institutions that adequately coordinate decentralized actors.

Mao believed in decentralization but did not know how to do it. Private ownership, production, and exchange, the institutions that coordinate a decentralized market economy, were part of the system he had fought against. His vision of a decentralized economy was a sea of independent communes, largely self-sufficient, with goods exchanged at prices set by the central government.

The result was an economy that alternated between failed centralization and failed decentralization. An initial five year plan on the Stalinist model was followed by a shift to decentralization, with state owned enterprises transferred from central to local control. Mao had convinced himself that, with sufficient will, agricultural output could be increased almost without limit, putting local authorities under pressure to report greatly increased output. At the peak of the Great Leap Forward the official statistics for grain production showed more than twice the amount actually produced. China exported grain in substantial quantity while thirty to forty million people starved to death.

After it became clear even to Mao that the Great Leap Forward was a failure, policy was reversed and the economy swung back in a more centralized direction. Eventually Mao became unhappy with that, concluded that what was needed to make communism finally succeed was to remake the minds of the people, and launched the Cultural Revolution, including an attack on the central bureaucracy. It was still going when he died.

At which point things got interesting.

# Getting One Thing Right

The removal from power of the Gang of Four, Mao’s widow and her allies, by a coalition of everyone else who mattered within the communist elite, left power in the hands of a loose coalition of people who had held high positions under Mao at some point in their lives. Many of them had been purged by Mao at least once during their careers, some, as punishment and correction, sent out to farming villages or factories to live the lives of ordinary Chinese.[[4]](#footnote-4) All of them were communists. All of them believed in socialism. All of them realized that something had gone terribly wrong with their implementation of it. Over the next six years, more than three million people who had been purged or persecuted under Mao were rehabilitated.

Under Mao’s rule, contact with the outside world had been sharply restricted. After his death that changed. Officials looking for an answer to the puzzle of what they had gotten wrong, how to use their superior economic system to produce superior results, took trips abroad to see what they could learn from the outside world. A vice-premier visiting England discovered that the oppressed working classes of the capitalist world were strikingly better off than Chinese peasants, workers, or even officials; a London trash collector had six times his salary. Returning to China, he wrote:

I think Britain has done a good job. Products are abundant; the three inequalities [that between urban and rural areas, between industry and agriculture, and between mental and manual labor, the elimination of which, according to Marx, was a critical task for socialism] are almost done away with; social justice and welfare have received a lot of emphasis. Britain would simply be our model of a communist society if it were ruled by a communist party. (pp. 155-156).

Other officials, visiting factories in Japan, observed how much better run they were than factories in China. Their conclusion:

“We are a socialist society. Our institution is much better than capitalism. But due to the lack of experience, we made mistakes in constructing socialism. As a result, the superiority of socialism has yet to be fully realized. … We will certainly fulfill the goal of Four Modernizations by the end of this century as long as we follow the basic roadmap pointed out by the Party, work diligently, and utilize the advanced technology and managerial know-how to serve the purpose of socialism." (p. 34)

Chinese officials also visited countries of eastern Europe, including Yugoslavia. What they saw there was evidence that socialism might take different forms in different countries. In attempting to discover the right form for China, they got many things wrong but one thing right. Having observed the catastrophes produced by Mao’s attempts to fit the real world to his theories, they concluded that it should be done the other way around. Theories were all very well, but facts trumped them.

Being good Maoists, they searched through Mao’s voluminous writing for something in support of that position–and found it. “Seeking truth from facts” was an old Chinese saying which Mao had endorsed and popularized during the Civil War. They might have rejected some of Mao’s actions but, by adopting that principle, they were supporting his thought, which was what mattered. The right approach to making socialism work, as seen and expressed most clearly by Deng, was to experiment with many different approaches, discarding those that failed and adopting those that succeeded.

A second decision, again based on their observation of what had gone wrong, was that economic production rather than ideological purity should be the first priority. That too was justified on the basis of existing ideology:

In line with Marxism, distribution according to need is impossible without an extreme expansion in commodity production. This is not beyond our reach, as seen from Japan. Capitalist Japan produced commodities in much more quantities and varieties than us. We are a socialist country. It is highly likely that we can reach their level of development and move beyond. (p. 34).

Once the Cultural Revolution had been terminated and its damage to some degree undone, the first priority was to reform the economy. Reforms, under the label of socialist modernization, included legalizing production for exchange, reintroducing some monetary incentives and permitting bonus and piece-rate payments in state firms. The next step, starting in 1978, was a ten year plan on the Soviet model, focused on the development of heavy industry. It worked badly enough to be canceled the next year.

Changes thereafter proceeded along two quite different lines. One was the official process of economic reform, largely an attempt by the central authorities to improve the functioning of the state owned enterprises, the part of the economy most directly under their control. The other consisted of what Coase and Wang refer to as marginal revolutions, changes originating on the periphery of the system, for the most part opposed by the authorities but not actively suppressed.

# Official Reform

By the end of 1978 Chen Yun and Deng Xiaoping, the only two surviving members of the pre-Cultural Revolution Politburo Standing Committee, had come back into power. They remained dominant through most of the developments into the early nineties, Deng as the central figure, Chen, who had been the architect of China’s original five year plan, as economic czar. Like many in the West,[[5]](#footnote-5) and with more excuse, Chen viewed Soviet central planning as a success, believed that it was bringing the Soviet economy to near parity with the U.S. His policy objective was the planned economy as primary, market adjustment as auxiliary; private enterprise was to serve in a subsidiary role to fill the gaps left by even a well designed plan. That had put him on the pro-market side of Mao but, in the post-Mao period, on the anti-market side of Hu Yaobang and Zhao Ziyang, party chairman and premier, both protégées of Deng.

Under Chen, official reform centered on what the officials regarded as the important parts of the economy. Some decision making power was shifted from national and provincial governments to local authorities. Policy shifted in favor of using foreign capital to develop projects, first in heavy industry, later in areas more directly relevant to consumer welfare such as housing. Enterprises were increasingly permitted to make some decisions and retain some profits. But the iron rice bowl system of lifetime employment with a single employer, under which firms provided a range of nonwage benefits[[6]](#footnote-6) and were not permitted to fire workers, remained in force, along with extensive regulation.

Firms that produced beyond the requirements of the plan were permitted to exchange the additional output with other firms on mutually agreeable terms. The result was a two tiered pricing system, an official price set by the central government for output under the central plan, a market price for additional output. That gave the management of the state owned firms experience with market interactions and market prices. It allowed actors outside of the state owned system to have access as inputs to the output of the state sector, even if only at the higher market price. But it also provided extensive opportunities for corruption by managers who could contrive to buy at the official price and resell at the market price.

By 1981 some high officials, including Hu and Zhao, were arguing in favor of switching state owned enterprises from planning to the price system. But since Chen, whose observation of the catastrophic results of the Great Leap Forward had persuaded him that too much decentralization would be a serious mistake, was unwilling to accept reforms that would eliminate central control over the economy, the end of price control was delayed for another decade.

The central authorities were also concerned with problems in the agricultural sector. There too, reform consisted of changes within the socialist model: An increase in the price offered by the state for agricultural products, a decrease in the cost charged for inputs. The result of the reforms by the central authorities was at best modest improvement. But meanwhile …

# The Marginal Revolutions

Unofficial economic revolutions proceeded in three different areas, at first only reluctantly tolerated by the officials: Privatization of agricultural land, production by firms nominally run by local governmental organizations, and small scale private employment in the cities. The first was illegal and at first covert. The second and third were legal but discouraged.

“The first recorded incidence of private farming in post-Mao China occurred in Pengxi county of Sichuan province, in a village called “Nine Dragon Hill.” This village was one of the poorest in Qunli Commune, widely known in the region as a “village of beggars.” One evening in September 1976, Deng Tianyuan, the Party secretary of the commune, summoned a small group of cadres to discuss the problem of agricultural production. After a long and heated debate, they agreed to try private farming as a solution to the managerial and incentive problems that had dogged collective farming. Aware of the political risk, they decided to allocate only marginal land to households in two production teams, while keeping collective farming intact elsewhere. That year, the output of the marginal but privately cultivated land was three times higher than that of the collectively cultivated fertile land. The next year, more land was privatized in more production teams. By 1978, before the Third Plenum was held in Beijing, private farming was practiced across the whole commune, but was kept secret from the local authorities. In 1979, at a meeting organized by the county government to discuss improvements in agriculture, Deng Tienyuan disclosed the secret of Nine Dragon Hill’s success and won the endorsement of the county Party secretary. The following year, a delegation from the Ministry of Agriculture and Forestry visited Nine Dragon Hill. While he criticized private farming in principle, the head of the delegation praised Deng Tianyuan for improving agricultural production and even proposed considering the village as an experimental site for private farming. (pp. 46-47).

Two years later in another village, also poor, privatization was secretly agreed on by eighteen peasants. It was sufficiently successful so that, as word of what they were doing spread, nearby villages joined in. Private farming remained illegal through 1979. In 1980 an exception was made permitting private farming *“*in those remote mountainous areas and poverty-stricken backward regions and in those production teams that have long been relying on state-resold grain for food, loans for production, and social relief,” and only “if the masses have lost their confidence in the collective.*”* The ban was finally lifted in 1982. By 1983, 95% of the rural population was under the household responsibility system, which put agricultural production under the control of the individual household rather than the agricultural commune.[[7]](#footnote-7) Mao’s view of private farming as a characteristically capitalist practice had been defeated by the Maoist doctrine that practice was the test of truth.

Mao’s failed attempts at rural industrialization during the Great Leap Forward had spawned a multitude of township and village enterprises. Many were closed down after the failure of the Great Leap, but not all. Such enterprises were legal but disfavored, viewed as inferior competitors to the large state owned enterprises. They bought inputs at market prices not the lower official prices, received no subsidies from the center. They were, however, free to make their own decisions about personnel, compensation, what they produced and how. To the surprise of the authorities, they turned out to provide the success that the centrally planned system failed to provide. As Deng wrote in 1987:

In the rural reform our greatest success – and it is one we had by no means anticipated – had been the emergence of a large number of enterprises run by villages and townships . . . Their annual output value has been increasing by more than 20 percent a year for the last several years. This increase in village and township enterprises, particularly industrial enterprises, has provided jobs for 50 per cent of the surplus labor in the countryside . . . This result was not anything that I or any of the other comrades had foreseen; it just came out of the blue. (p. 53-4).

By the mid-1980’s, township and village enterprises produced one quarter of China’s industrial output.

Meanwhile a third marginal revolution was occurring in the cities. Under Mao, China had had a continuing problem of urban unemployment. Unemployment was supposed to be a problem limited to capitalism, so Mao solved it by sending unemployed urban youths out to the countryside to be peasants. His successors, unwilling to continue that policy, instead decided to legalize small scale private employment in the cities as a way of soaking up some of the unemployed labor. Private firms were in theory limited to a maximum of seven employees. In practice, ones that grew beyond that point could put on a red hat, put themselves under the nominal authority of a local street committee or township or village government.

That part of the economy prospered.

Self-employed barbers, for example, came to earn higher incomes than surgeons in state hospitals. Street vendors who sold noodles and snack foods earned more than nuclear scientists. Traders, small shop and private restaurant owners, many of them the former “youths waiting to be employed,” were among the highest income groups in China during the 1980s. Not surprisingly, the number of self-employed household businesses and single proprietorships increased from 140,000 in 1978 to 310,000 in 1979, 806,000 in 1980, and reached 2.6 million in 1981. (p. 68).

Each of these successes occurred despite the intentions and expectations of the authorities, not because of them. The one thing the authorities did right, in each case, was not stopping them.

The authorities played a more active role in the fourth marginal revolution. Shenzhen was a village adjacent to Hong Kong through which many illegal immigrants passed. In 1979 Deng, back in power, responded to requests for more soldiers to guard the border by saying that it was not a problem the army could solve. The party secretary of the province in which Shenzhen was located investigated the situation and discovered the existence of two Luofang villages, one on the Chinese side of the Shenzhen river, one on the Hong Kong side, the second populated largely by refugees from the first. The average income of the Hong Kong Luofang was nearly a hundred times that of the Chinese one. He concluded that Deng was correct.

Instead of trying to solve the problem with more border guards, a special economic zone including Shenzhen was created within which Hong Kong businessmen and other foreign investors would be permitted to start businesses. The plan was to use such zones to experiment with capitalist principles that might be useful to a socialist economy, to “appropriate capitalism for the good of socialism.” The initial zones were located in places of little importance to the Chinese economy so that if the experiment proved a failure nothing much would be lost. They were intended as a way of quarantining dangerous ideas to prevent them from infecting the greater society while at the same time extracting whatever in them was of value.

Over the next thirty years, Shenzhen expanded from a village of 30,000 inhabitants to a city of fourteen million, pulling in ambitious Chinese from all over the country. In 1984, the authorities responded to the success of the first four zones by authorizing fourteen more. Still more followed.

By the end of the 1980’s the reforms appeared, for a number of different reasons, to be running into trouble. Some were stopped, some reversed. Zhao Ziyang had been removed as General Secretary of the party, in part because of perceived difficulties with reform, in part for his refusal to endorse the use of lethal force against the Tienanmin demonstrators. The number of private firms shrunk sharply. Political campaigns were instituted against the private sector on ideological grounds. The collapse of the Soviet Union raised fears of the dangers of going capitalist.

Deng Xiaoping had been the nearest thing to a central figure in the post Mao communist party, although the top positions in party and government had been held not by him but by his protégées. By 1992 he was eighty years old and had resigned all official positions. His two most important protégées had been Hu Yaobang and Zhao Ziyang, but Hu was no longer alive and Zhao out of power and under house arrest.

In January of that year, disturbed at the retreat from reform, he traveled with his family and staff through southern China, the area most friendly to market institutions, giving talks to local officials in support of reform and continued experimentation. No Chinese media reported the talks at the time. More than a month later, a Shanghai newspaper reported on his trip; the story was then taken up and repeated by other media, setting off a lively debate within party circles. In April, Vice Premier Tian Jiyun came out in support of Deng’s position in a talk at the Central Party School. The talk was videotaped and copies sold on the streets of Peking. Other officials followed, and policy swung back towards continued reform. The reader is left with the picture of a state run by the consensus of an elite whose members might sometimes disagree about what was best for China but were agreed in wanting economic progress for the nation and civil relations with each other.[[8]](#footnote-8)

After Deng

By the early 1990’s, the success of the marginal revolutions was enough to convince the Chinese leadership to endorse what they had before only tolerated, to shift the economic model from one dominated by central planning to one controlled mostly through the market, a “socialist market economy.” In 1992, the number of items whose prices were set by the central government was reduced from 737 to 89. By 1996 the dual track pricing system was gone. In 1990, Shanghai started a stock exchange, following one in Shenzhen that had opened without official permission in 1988 and was finally approved in 1991. In 1992, the Pudong New District, a special economic zone adjacent to Shanghai, was approved. By 1996, town and village enterprises were employing 126 million people and producing 26% of Chinese GDP.

The share of state enterprises in industrial production fell from 77.6% in 1978 to 34% in 1995. By 1994, about half of them were insolvent; covering their losses was absorbing nearly a tenth of government revenue. Starting in 1992, Zhucheng, a small city a majority of whose state or collective enterprises were reliant on subsidies that the local government could no longer afford, privatized 272 out of 288 of them. The pattern was imitated elsewhere. As firms were privatized, lifetime guaranteed employment was replaced by unemployment insurance and a state pension plan, public housing sold at below market prices to its current occupants.

One important result of the reforms of the 1990’s was that they let firms and localities compete on something close to an even playing field. In the earlier period, each state owned enterprise negotiated with the officials in charge the tax it would pay or subsidy receive, the amount it would produce, the price it would sell its output to other state owned enterprises at. The result was a system where there was no easy way of telling what enterprises were well or badly run, since enterprise profits largely depended on the particular terms negotiated. Once administered prices were replaced by market prices and negotiated terms replaced with a fixed value added tax, that situation changed. Not only could firms, especially private firms, compete, local governments could compete as well.

The political system in China was sufficiently decentralized to permit the approach that Deng had endorsed, a wide range of experimentation by local governments. Some experiments failed and vanished, others succeeded and were imitated. One of the latter was the development of industrial parks. Administered by governments at various levels, they competed with each other to attract private firms by providing both services such as water and electricity and assistance in interfacing with the governmental system to obtain permits and meet other requirements. The governments functioned, in effect, as private landlords. Local officials were appointed from above but, since the central government viewed economic growth as its chief priority, promotion was largely dependent on economic performance, giving local officials an incentive to try to create institutions that led to economic growth.

*“When each of the local Chinese governments, including 32 provincial level governments, 282 city governments, 2862 county governments, 19,522 town and 14,677 village governments, tests out its way of developing the local economy, numerous different experiments are conducted simultaneously, each in competition with the other. The time of collective learning based on trial and error is cut significantly. The diffusion of successful practices is made fast and easy . Regions compete not only in factor markets – capital and labor have become increasingly mobile since the mid-1990s – and product markets, but also in the provision of local public goods, the structuring of business–government relations, and the local organization of production.” (p. 173).*

# Socialism is Dead. Long Live Socialism.[[9]](#footnote-9)

China’s transition to capitalism was, from beginning to end, done under the banner of socialism. At the beginning, the leaders were united in wanting to make China “a powerful, modern, socialist country” (1978). It did not take long for them to revise their mission to put in place “socialism with Chinese characteristics” (1982) and “a commerce economy with plan” (1984), before finally embracing “a socialist market economy with Chinese characteristics” (1992). (p. 83).

Economists define socialism as a system of government ownership and control of the means of production, but in the political context it had and has a much vaguer meaning, often little more than an approving (or disapproving) label almost empty of content. By the end of the transition, the Chinese authorities were defining it as:

The essence of socialism is liberation and development of the productive forces, elimination of exploitation and polarization, and the ultimate achievement of prosperity for all. (pp. 116-117)

And Deng could write that “The essence of Marxism is seeking truth from facts.”

One striking pattern was the upside down nature of reform. It was least successful in the part of the economy initially targeted, the system of state owned enterprises and state managed agriculture. Because the authorities were operating under an incorrect economic theory, their attention prevented the changes that would have made reform successful.[[10]](#footnote-10)

The parts of the economy that experienced successful change were the parts considered unimportant,[[11]](#footnote-11) hence largely ignored, hence free to shift towards the pattern of private property and exchange that the authorities disapproved of but were unwilling to entirely prevent. The one success due to deliberate decisions by the authorities, the creation of special economic zones, succeeded in a way the authorities did not intend. The zones, intended to serve as special reservations within which capitalist institutions could be isolated for study in order that the useful parts could be adopted into socialism, instead spread capitalist institutions through a large part of China. The exception swallowed the rule.

The authorities deserve little credit for planning the successful transition but considerable credit for letting it happen. Throughout the process, they accepted the principle that facts trumped theory. Deng, at least, supported the idea of experimentation as a source of knowledge. When economic success occurred in parts of the economy that had been left mostly to their own devices, they were willing first to permit what was happening and then to alter their theory to take account of the observed facts.

Coase and Wang end their book with one substantial reservation. The market for goods in China is now substantially free, despite the survival of some state owned enterprises. The market for ideas is not. The university system is under the control of the central government. They argue that while China has been able to prosper to this point largely as a producer of products designed elsewhere, further prosperity will require a degree of innovation and open mindedness that current institutions do not encourage. They offer as evidence the puzzle propounded by Qian Xuesen, a respected Chinese scientist: “Why have Chinese universities not produced a single world-class original thinker or innovative scientist since 1949?” (p. 191)

# **Part II: Coase and China**

Prior to the publication of “The Problem of Social Cost,” economists knew, on straightforward theoretical grounds, how externalities should be dealt with: Impose a Pigouvian tax to force the creator of the externality to internalize it. After its publication, economists who viewed the Coase Theorem as a full explanation of what Coase had written again knew the answer on straightforward theoretical grounds: Define property rights and let the parties bargain to the efficient solution.

The problem was more difficult for economists who had read Coase’s article as he intended it to be read. The observation that in a world of zero transaction costs parties would bargain to the efficient outcome provided only that the relevant rights were clearly defined was one step in a more complicated analysis. Its point was less to show what did happen then to explain what did not happen and why.

Conventional price theory treated the firm and the market as black boxes. The firm was defined by a production function and the supply and demand curves that function implied. The market was assumed to match buyer and seller smoothly, instantly, costlessly. The institutional structure of both was unimportant, the cost of arranging transactions implicitly assumed to be zero. [[12]](#footnote-12)

In “The Problem of Social Cost,” Coase showed that if one took the final assumption seriously, the problem of externalities vanished. In “The Nature of the Firm” he demonstrated that, under the same assumption, there was no reason for firms to exist; in a world where transactions were costless the coordination problem could be solved by an atomistic economy in which production was organized by market transactions between individuals. That, as he later pointed out, was one implication of the arguments by which economists, in the course of the calculation controversy, had demonstrated that a centrally planned economy was neither possible nor necessary. A firm is a miniature planned economy, a hierarchical structure within which production is coordinated by command rather than by prices and free exchange.[[13]](#footnote-13) The capitalist beach largely consists of socialist grains of sand. Why?

Coase’s conclusion was that both firms and the problems associated with externalities existed because of the transaction costs that price theory had assumed away. In order to understand firms, problems of market failure, economics beyond the simple model, it would be necessary to drop that assumption.[[14]](#footnote-14)

One approach to doing so would be to expand the theoretical structure to include transaction costs; Coase’s two articles could be read as first steps in that direction.[[15]](#footnote-15) In his view, however, the first step was not theory but facts. Given the lack of an adequate theory of transaction costs, economists should look at how they manifested themselves and were dealt with in the real world, in firms, contracts, markets. Theory, what Coase referred to as “blackboard economics,” could not do it. Perhaps in some far future when the logic of transaction costs was fully understood a much improved version of pure theory could.[[16]](#footnote-16) But the job for the current generation of economists was to accumulate real world information, to “seek truth from facts.”[[17]](#footnote-17) Coase’s approach to the problem of reforming the field of economics was the same as Deng’s to the problem of reforming the economy of China.[[18]](#footnote-18) Both assumed an initial lack of knowledge. Both prescribed the same approach to dealing with it.

There is a second respect in which the Chinese experience might have been of special interest to Coase–as a source of data. After the death of Mao and the collapse of the Soviet Union, both China and eastern Europe faced the problem of converting their economies from communism to something that worked. Russia and the countries of eastern Europe received plentiful advice from western economists and, to some degree, attempted to act on it, to redesign their economies by plan, by blackboard economics, on western models.

The Chinese, perhaps because they were the heirs to what had been, until the humiliations of the 19th century, a supremely self-confident civilization, perhaps because the final dynasty’s attempts at westernization had not proved a striking success, perhaps because they believed that they were building a socialism superior to capitalism, took a different approach. If Chinese socialism had failed, it was because they were not doing socialism right. It was up to them to find out what they were doing wrong and fix it. The approach was not to copy existing capitalism[[19]](#footnote-19) but to rebuild their economy by experiment, by trial and error, guided but not constrained by theory. “The essence of Marxism is seeking truth from facts.”

Following that policy they felt their way, step by step, to a market economy that they had themselves invented. Agricultural land was held not as freehold property on the model of Anglo-American common law but under the Household Responsibility System. Their equivalent of a western industrial park was a hybrid institution combining the functions of landlord and local government. Township and village enterprises were constructed out of remnants of the decentralized institutions of Mao’s Great Leap Forward.

Ronald Coase’s program was to use observed institutions as the data, the raw material, for the next step in the development of economics. More data is better than less. The failures and the successes of the Chinese transition provide a mass of new data. That helps to explain why, in his interview with Wang, Coase proposed what Chinese economists should do was “to study the Chinese economy based on how it actually works.” The ultimate objective was not to understand China. It was to understand economics.[[20]](#footnote-20)

**Part III: Is It True?**

My account of the history so far has been based on the account given by Coase and Wang, itself based largely on statements by the chief players in the story, especially Deng. That raises an obvious question.

Consider the situation faced by Deng in 1978, when he returned to power. His view, shared with most of the senior members of the party, was that the priority was now not class struggle but economic development. One approach to achieving that objective, again widely shared once it became clear how far behind China was, was to import foreign technology, study foreign management techniques, take advantage of the opportunities provided by foreign markets, end Mao’s policy of economic isolation. That approach to the outside world was compatible with two quite different approaches to the internal economy. One was central planning along Soviet lines. The other was a shift to a market economy. Chen Yun, who supported the former option, was the senior party member with most expertise in economics. Under Deng, he played the central role in at least the early stages of reform.

Suppose that Deng had concluded that the way to bring China up to the level of the developed countries of the West was to abandon socialism in favor of a market economy. Saying so would have been imprudent, probably disastrous. He had successfully pushed the idea that Mao might have sometimes been wrong, hence that some of his decisions, such as the mass purges of the Cultural Revolution, ought to be reversed.[[21]](#footnote-21) Going beyond that, proposing the wholesale abandonment of socialism, was not an option.

The approach Deng took was. It was clear to everyone that their implementation of socialism had something seriously wrong with it. Observation of communist countries in Eastern Europe, especially Yugoslavia, raised the possibility of different variants of socialism. Chen, the supporter of central planning, also supported the use of markets, although only as a supplement. Hence it was possible to get support for a policy of experimentation. Once experiments demonstrated their success, it was possible, given the shared emphasis on economic development, to find ways of fitting them into a revised version of a socialist economy.

That raises the possibility that Deng may have been a better economist and a less honest reporter of his own views than Coase and Wang assume. The policy he followed could be interpreted as he presented it, experimentation in variants of socialism with no clear theory as to which would be best. It could also be interpreted as a way of facilitating a gradual transition to a market society without violating the political constraints. One interpretation supports the thesis of Coase and Wang, one does not.

There is no way to be certain which interpretation correctly describes Deng’s views when he first came to power. It seems clear that by the early eighties, he had concluded that the increased use of markets was the right strategy.[[22]](#footnote-22) After the economic difficulties of 1988 and the Tienanmen demonstration in 1989, both Chen and Deng agreed that the best way of preventing difficulties was continued economic growth. Chen’s conclusion was that the pro-market reforms should be scaled back, Deng’s that they should be resumed. As a result of his southern tour in 1992, Deng succeeded in persuading his successors to adopt his policy.

The situation is clearer in the case of Zhao Ziyang, premier from 1980, General Secretary of the party from 1987 and a committed supporter of reform. In 1989, already suffering criticism because of inflation and an unsuccessful attempt to reform the price system, Zhao refused to support the use of lethal force against the Tienanmen demonstrators, was removed from power and spent the rest of his life under house arrest. While imprisoned, he recorded his experiences and views on about thirty cassette tapes, each about sixty minutes long, probably made about the year 2000.

After his death in 2005, the tapes were assembled and an edited version published. They provide an inside account of the Chinese transition composed by one of the chief participants, produced at a time when he no longer had any significant chance of returning to power, probably not intended to become public until after his death. For that reason and on internal evidence, I take it as an honest account. It shows that even before Mao’s death Zhang favored a shift from the planned economy to a market economy, while uncertain as to how far the shift could be carried.

“I also progressed through stages in my understanding of the planned economy. In the beginning, I was concerned that in a country as big as China, with its divergent conditions and underdeveloped communications and transportation networks, if all commodities from production to distribution were centrally directed and planned, then bureaucratic red tape, breakdowns, and mistakes seemed inevitable. Later, after I’d come to work at the Central Committee, [1973] I realized that economic inefficiencies and the breakdowns between production and consumption had an inherent cause, and that was the planned economy itself. The only way out was to realize market potential by allowing the laws of supply and demand to take effect. I had no idea, though, whether or not we, as a socialist country, could adopt the free-market fundamentals of Western nations.” (p. 123).

Describing views reached later, probably after his fall from power, he wrote about the agricultural sector: “It is very possible that a more suitable form is the family farm operation. In order to adapt to this kind of demand, the ability to freely trade, rent, and inherit land should be permitted and the most important rural productive resource, the land, should be made freely available on the market and given legal protection. This is an issue that must be confronted.” (p. 144).

Assuming, as I do, that Zhao’s account can be trusted, it is necessary to qualify the thesis offered by Coase and Wang. Within two years of Deng’s assumption of power, the premier of China, the person with chief official responsibility for the economy, was a man who recognized the inherent problems with a centrally planned economy and supported a shift in the direction of markets. For at least eight years thereafter, he had the continued support of Deng. After his fall from power Deng continued to press for the economic policies Zhao had favored.[[23]](#footnote-23)

The thesis is correct, however, as a description of the leadership as a whole. Chen Yun, Deng’s near equal in importance and the chief authority on economic issues among the senior party members, favored central planning with a limited role for markets. That position was shared by some but not all of the collective leadership. When, as in 1989, there appeared to be problems with economic reform, the consensus was for a shift away from market arrangements, a consensus accepted at least briefly by Deng.

Finally, it should be noted that very nearly nobody in the leadership, including Zhao prior to his fall, supported the full scale reintroduction of capitalism. The government retained, and still retains, a sizable role in the economy.[[24]](#footnote-24) Agriculture was decentralized down to the household but never entirely privatized. Arguably one reason was unwillingness to accept a degree of privatization that would seriously reduce the power of the party.

**Part IV. How To Fix an Economy**

The central thesis of Coase and Wang is that economic development is best done not by planning but by a decentralized process of trial and error. They offer the experience of China as evidence in support of that thesis. Despite later claims by some in the leadership, successful reform in the initial period, prior to Deng’s southern trip in 1992, occurred as a result of marginal revolutions at best tolerated by the authorities, occurred not because of but in spite of planning from the center. Successful reform in the later period was due to changes, decentralization and the shift to a reasonably uniform system of taxation, that created a competitive market for reform by local governments, a Chinese version of the Tiebout model.

Is that evidence against planning or only against bad planning? Suppose the central figure in the earlier period had been not Chen Yun but Zhao Ziyang or, less plausibly, some Chinese equivalent of Chile’s Chicago boys. Would a deliberate policy of privatizing agricultural land, selling off state owned enterprises, decontrolling all prices, introducing a system of legal rules based on western models, have produced even better results than what actually happened?

One piece of evidence against is the experience of the ex-communist states of eastern Europe, which followed something closer to that approach. It was tolerably successful in those states, such as the Baltics and the Czech Republic, that had become communist only as a result of Soviet invasion, much less successful in the ex-Soviet states. But even at best, the results were not nearly as striking as those of the Chinese reforms.

That is evidence but not very strong evidence because, as in most such comparisons, there are other possible explanations for the differences. Control of China by the CCP only dates from 1949,[[25]](#footnote-25) making its situation arguably more like that of the eastern European satellites than that of the Soviet Union. China started its reforms much poorer than the eastern European states, arguably giving it more room to grow. And the Chinese communist party, unlike the Soviet and eastern European parties, remained in power throughout. One could view the difference in outcome as reflecting the advantages of reforming the economic system before the political system. Finally, China was a special case for reasons unrelated to its recent history, an ancient culture that had functioned, for the most part peacefully, for more than two thousand years.

A different approach to the question is provided by evidence on the dark side of Chinese reform, corruption, described in considerable detail by Yan Sun.[[26]](#footnote-26) For the system of competitive government reform described by Coase and Wang to produce consistently good results, two conditions must be met. One is that the benefits to one region do not, on net, come at the cost of other regions. The other is that the officials controlling local reform have as their chief objective advancing their careers by making their regions prosperous. Yan presents evidence of problems with both.

One way to make your region prosperous is by swindling other regions. An example is provided by Miluo, a remote city in Hunan, which produced fake pesticides in large quantities and exported them to 131 counties in 17 provinces.[[27]](#footnote-27) Another is by swindling the central government. A feature of the value added tax system that was introduced in 1985 provided for refunds to firms that exported their products. That provided an attractive opportunity for a region with sufficiently well organized corruption, especially a poor region where other opportunities were few. Create documentation for the production, taxation, and export of imaginary commodities. Use that documentation to claim refunds on imaginary taxes. Over a period of four months in 1992, five firms in the city of Xianning conspired with local authorities to claim Y12 million in rebates from the central government.[[28]](#footnote-28) Yan, who offers other examples of ways in which local officials enriched their regions at the expense of either other regions or the central government, argues that they were a consequence of the political decentralization that Coase and Wang see as the mechanism promoting reform. She views that as one explanation of the striking increase in the frequency and scale of corruption from the period before Deng’s southern trip to the period after.

One strategy which an ambitious official could follow was to enrich his region and so earn promotion. An alternative was to plunder his region, reducing his chance of promotion but increasing his current income.[[29]](#footnote-29) In poor regions that might mean using money that the central government provided for helping the poor to pay for automobiles, fancy office buildings and elaborate feasts, all for the officials. It might mean creating a system of fines and fees designed not to regulate behavior but to funnel money to the officials.[[30]](#footnote-30) In Beijing, operating an automobile required the payment of eleven different fees.

These examples demonstrate that administrative decentralization was at best an imperfect mechanism for generating efficient economic regulation. It does not follow that there existed a better alternative. Going back to the question of whether a more wholesale and deliberate reform in the direction of markets would have done better, it is worth asking to what degree corruption was a result of too large a shift towards markets and decentralization, to what degree of not enough of a shift in that direction.

The most common form of corruption in the first period of reform was based on the two price system, which made it possible for officials in state owned enterprises to buy goods at the low controlled price and resell them at the higher market price. As Yan points out, this form of corruption was to some degree benign, since it could move goods from lower valued uses within the state plan to higher valued uses outside it.

The abolition of the two price system for goods eliminated that particular opportunity. But the later period retained a two price system for capital. A corrupt official could borrow money on behalf of a state owned enterprise or a government project under his authority at the low official rate, loan it out at the higher market rate. That practice would have vanished if China had gone all the way to a private market for loans.

There is, however, an argument in favor of the book’s thesis broader than such specific examples suggest, one that brings us back to the critique of blackboard economics that is central to Coase’s work. In a world of perfect knowledge and zero transaction costs, economic reform would be simple. Every society would move instantly, via a Coasian bargain, to the efficient set of institutions, presumably laissez-faire. In the real world, it is not that simple.

If Deng, advised by a suitable selection of graduates of the University of Chicago economics department, had attempted an immediate shift to a market economy, he would have been removed from power. He was able to make the transition only because it was done in a way that could, at each stage, be represented not as abandoning socialism but as improving it. Seen from that standpoint, the inefficiencies associated with the dual price system or the incomplete conversion of land to private property were costs that had to be born in order to make the associated improvement politically acceptable to the communist elite, arguably to the masses as well. And by representing reforms, especially in the later period, as experiments that could be terminated if results were unfavorable he made them more acceptable to those who expected that they probably would not work, hence would not last. Not only did this approach make reforms ideologically acceptable to the communist elite, it preserved the power of the communist party. That made the reforms more acceptable to people most of whom would have lost their power, possibly their lives, if the party had fallen, as the Soviet party did. And it avoided the problems of combining a political transition with an economic transition.

The argument applies not only to the top level of reform, the political system imposing it, but to the lower layers at which it is implemented. A market system built on contract and property rights depend on a legal system that protects and enforces them, which in turn depends on a structure of norms, customs, expectations. As Yan Sun makes clear, much of that did not exist even after reforms had been imposed. The trial and error approach actually followed meant that ideas that were good in theory but not in practice, given the actual characteristics of the population, got tried and rejected.

Consider, for a simple example of the problem, Edward Banfield’s description of the differences between two towns, one in post-war southern Italy, one in America.[[31]](#footnote-31) In the Italian town, individuals assumed that others could not be trusted and were correct. In the American town, individuals assumed others could be trusted and were correct. An individual who trusted others in the former environment would be taken advantage of. An individual who failed to trust others in the latter environment would miss valuable opportunities. Each society was in a Nash equilibrium. Economic reforms that worked in one might well fail in the other.

Consider again the two price system for government owned enterprises during the early stages of reform. One advantage of that over a full scale shift to market prices was that it preserved a large enough element of central planning to be acceptable to Chen Yun and others who shared his views. A second advantage was that it gave officials working in those enterprises first hand experience of market transactions, finding buyers and sellers, negotiating prices, without entirely removing them from the system with which they were familiar. That made it easier, as reform continued, for some to transition out of the state owned sector and for others to continue to function in that sector as it moved further and further away from central planning.

Coase’s view, going back long before this book was written, was that we do not know, on the basis of economic theory, how institutions should be designed, because we do not know enough about the factors that are omitted from the simple textbook models of economics. That is an argument for trial and error reform based on experiment and real world results. Arguably, it is the mechanism by which existing market societies are structured. The legal framework may be handed down from above,[[32]](#footnote-32) but the institutional structure, individuals choosing organizational forms within which to organize their activities, is produced by trial and error, firms and alternatives to firms coming into existence, succeeding and being copied, failing and going out of existence.

That is the process that China has followed, on a wider scale, with striking success.

**References**

Banfield, Edward, *The Moral Basis of a Backward Society*, Free Press 1958

Coase, R.H., *Essays on Economics and Economists*, University of Chicago Press, Chicago, 1994.

Coase, R.H., *The Firm, the Market and the Law*, University of Chicago Press, Chicago, 1988. Contains “The Nature of the Firm” and “The Problem of Social Cost.”

Coase, Ronald and Wang, Ning, *How China became Capitalist*,

Coase, Ronald, interview by Ning Wang, 2011, webbed at:

http://english.unirule.org.cn/Html/Unirule-News/20110101130956819.html

Dikötter, Frank, *The Age of Openness: China before Mao*, University of California Press, 2008.

Friedman, David, *The Machinery of Freedom: Guide to a Radical Capitalism*

"The World According to Coase," Reason Magazine, 1991, pp. 1-4

http://www.daviddfriedman.com/Academic/Coase\_World.html

*Law’s Order: An Economic Account*, Princeton University Press, Spring 2000.

Friedman, Milton and Rose D., *Two Lucky People*, University of Chicago Press 1998.

Hazlitt, Henry, *The Great Idea,* New York: Appleton 1951. *Reprinted as Time Will Run Back,* London: Ernest Benn Ltd., 1952.

Levy, David M. and Peart, Sandra J., Soviet Growth & American Textbooks (December 3, 2009). Available at SSRN: <http://ssrn.com/abstract=1517983> or <http://dx.doi.org/10.2139/ssrn.1517983>

Vogel, Ezra F. (2011-09-26). *Deng Xiaoping and the Transformation of China*. Harvard University Press. Kindle Edition.

Bao Pu, Renee Chiang, and Adi Ignatius, translators and editors, *Prisoner of the State: The Secret Journal of Premier Zhao Ziyang*. S&S eBooks. Kindle Edition.

Sun, Yan, *The Chinese Reassessment of Socialism, 1976-1992,* Princeton 1995.

Sun, Yan, *Corruption and Market in Contemporary China*, Cornell 2004.

1. Quoted on page 25 of *How China Became Capitalist*.All page references in this article are to that source unless otherwise identified. [↑](#footnote-ref-1)
2. Webbed at http://iep.clemson.edu/wp-content/uploads/2012/04/WangNingCoaseInterviewDec2010.pdf [↑](#footnote-ref-2)
3. “We must not follow the example of the Soviet Union in concentrating everything in the hands of the central authorities, shackling the local authorities and denying them the right to independent action.” (p. 57) (Mao talk in 1956). [↑](#footnote-ref-3)
4. Deng Xiaoping, the central figure in the post-Mao coalition, had been General Secretary of the Central Secretariat of the party under Mao. During the Cultural Revolution he was labeled “number two capitalist roader” and spent several years as a worker in a rural tractor factory. In 1973 he was called back to Beijing as vice premier, then promoted to First Vice Premier. In 1975 Mao deposed him a second time for reluctance to endorse the Cultural Revolution, to agree that it had been, on the whole, a good thing. Zhu Rongji, premier from 1998 to 2003, had been purged twice and exiled to the countryside for five years. [↑](#footnote-ref-4)
5. The 1961 edition of Samuelson’s principles suggested that the GNP of the USSR would pass that of the U.S. sometime between 1984 and 1997. The 1963 edition of McConnell’s competing textbook claimed that the rate of economic growth in the USSR was two to three times as great as that of the United States. Both books contained claims along those general lines through 1990, despite the fact that both showed the ratio of GNP between the two economies to be roughly constant throughout that period. (Leavy and Peart) [↑](#footnote-ref-5)
6. Such as housing, daycare, schooling, medical care and pensions. [↑](#footnote-ref-6)
7. The system fell well short of full private property:

   “In the end, the way that was chosen, “contracting down to the household,” retained public ownership of the land and allowed local officials to assign a certain production quota to each individual household. In the contract with the household, village officials specified which crops the household had to cultivate and how large the quota turned over to the government should be. In the contract, the local officials agreed to supply the land and machinery to the household and in return, after the harvest, the household would turn over a certain amount of grain and other crops. If a household no longer had enough able-bodied people to work the land, village leaders could reassign the land to other households. (Vogel, p. 442). [↑](#footnote-ref-7)
8. According to Vogel, the southern tour included a meeting with military leaders, who supported Deng’s call for renewed reform. “The Zhuhai meeting is not mentioned in books on the southern tour published in mainland China, nor is it noted in the official chronology of Deng's life, *Deng Xiaoping nianpu*. This omission is understandable, for Communist Party leaders do not want inner-party tensions to be revealed in public. But news of the meeting leaked from participants and from observers in Zhuhai and was, in effect, confirmed by the reactions of Jiang Zemin in the weeks following the meeting. The strong representation of military leaders made it clear that if necessary, the high-level military brass was willing to support a new leader. (Vogel p. 677). [↑](#footnote-ref-8)
9. See Friedman 1973, Chapter 23, “Creeping Capitalism,” for an early discussion of how a socialist economy might become capitalist under the banner of socialism. For a still earlier (fictional) portrayal of the gradual conversion of a communist state to capitalism, see Henry Hazlitt, *The Great Idea*, 1951. [↑](#footnote-ref-9)
10. “Any reform targeting the economic core of socialism was inevitably directed and closely supervised by the state. In both cases, the Chinese leaders could not afford to take their hands off the economic sector which they deemed vital for both the wellbeing of the whole socialist economy and for political stability. The heavy-handed approach they took implies that the state-led efforts were severely constrained by socialist ideology; more often than not this resulted in disappointing outcomes. This was the price China paid for its remaining commitment to socialism.” (p. 165).

    A further problem with official reform was that any substantial change in authority over the government run part of the economy threatened the position of government officials who would accordingly resist it. That seems to have been part of the reason that the project of separating the party from the government, although supported by, among others, Deng, was never really implemented. That was less of a problem for the expansion of parts of the economy outside direct control. [↑](#footnote-ref-10)
11. Agriculture was an exception, since shifting resources away from heavy industry and towards agriculture was part of Chen Yun’s original design for modifying the central plan. But his proposal was set within the context of the existing institutional model and it was the abandonment of that model that ultimately produced the major improvement. [↑](#footnote-ref-11)
12. “The world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave.” Coase 1988, p. 174. [↑](#footnote-ref-12)
13. “How could the views expressed by economists on the role of the pricing system and the impossibility of successful central economic planning be reconciled with the existence of management and of these apparently planned societies, that is, firms, operating within our own economy? Coase 1994 p. 7. [↑](#footnote-ref-13)
14. “Economists, following Pigou whose work has dominated thought in this area, have consequently been engaged in an attempt to explain why there were divergences between private and social costs and what should be done about it, using a theory in which private and social costs were necessarily always equal. It is therefore hardly surprising that the conclusions reached were often incorrect.” Coase 1988 p. 175. [↑](#footnote-ref-14)
15. See Friedman 1991 and Friedman 2000 Chapters 6 and 10 for attempts to incorporate the Coasian approach to externalities into economics. For attempts to do the same with Coase’s view of the firm see work by Demsetz, Williamson, and others. [↑](#footnote-ref-15)
16. Game theory was intended by Von Neumann to provide a mathematical theory of strategic behavior, one major source of transaction costs. That one of the most brilliant theorists of the century tried and failed to solve that problem is support for Coase’s view of the difficulty of the project. [↑](#footnote-ref-16)
17. “An inspired theoretician might do as well without such empirical work, but my own feeling is that the inspiration is most likely to come through the stimulus provided by the patterns, puzzles and anomalies revealed by the systematic gathering of data, particularly when the prime need is to break our existing habits of thought.” Coase 1988 p. 71. [↑](#footnote-ref-17)
18. “What we do is all experiment.” Coase 2011. [↑](#footnote-ref-18)
19. One point not noted by Coase and Wang is that Chen Yun’s position, central planning as primary, markets as secondary, was the prevailing view of western development economists as well. Arguably, the socialists of China abandoned socialism as a tactic for economic development a little before the economists of the capitalist world abandoned it, perhaps because of more first hand experience. [↑](#footnote-ref-19)
20. “There is a lot more to learn from how the market economy with Chinese characteristics operates and evolves over time. If the Chinese economists rise up to the challenge, they will contribute to the development of economics.

    Here is a letter to Sheng Hong I wrote in 1988. There I said that I had a "firm believe that an understanding of what is happening, and has happened, in China will greatly help us to improve and enrich our analysis of the influence of the institutional structure on the working of the economic system".”

    …

    “What Chinese economists should do is to develop their own thinking based on a careful and systematic investigation of the working of the Chinese market economy.” (Wang interview with Coase) [↑](#footnote-ref-20)
21. The initial disagreement between Deng and Hua Guofeng, Mao’s chosen successor, was over Ha’s support for “the two whatevers,” the doctrine that whatever policies Mao supported and whatever instructions Mao gave should still be followed. [↑](#footnote-ref-21)
22. “Comrade Deng Xiaoping had long emphasized the power of the market. ‘Socialism does not exclude a market economy,’ he said. He repeated the message many times. He said that, in combining planned and market economies, we could be flexible as to which was actually playing the leading role. The Decision on Economic Reform passed at the Third Plenum of the 12th Central Committee [in 1984] stressed the importance of the natural laws of supply and demand and the power of the market. It defined the economy of socialism as that of the ‘commodity economy’.” (Zhao Ziyang in Pu et. al. p. 119).

    “Of course, by 1992, Deng had expressed this opinion more clearly in his talks. Even though he said different things at different times, he was always inclined toward a commodity economy, the laws of supply and demand, and the free market.” (p. 120).

    “Deng believed in expanding the economy with an emphasis on speed and opening up to the outside world, adopting reforms that moved toward a market economy. Chen Yun upheld the approach of the first Five-Year Plan in the 1950s; that group insisted on a planned economy and had reservations about the reform program.” (p. 91) (Zhao, describing the situation after the Third Plenum in 1978.) [↑](#footnote-ref-22)
23. The issue that ultimately cost Zhao Deng’s support was not economic reform but political reform. Deng was strongly opposed to introducing anything along the lines of multiparty democracy or division of powers. While Zhao did not favor a full scale shift to a western political model until well after his fall from power, he was in favor of increased separation of party from government. [↑](#footnote-ref-23)
24. Milton Friedman, in his and Rose Friedman’s autobiography, describes his interviews in 1988 with Zhao and in 1993 with Jiang Zemin,, then general secretary of the party and president of the People’s Republic. He concluded that Zhao was a good natural economist who understood the nature of a market system. The same was not true of Jiang:

    “Several things became clear in the course of his talk. His image of what he repeatedly referred to as a socialist market economy was very different from Zhao’s or ours. He viewed the market strictly as a mechanism to be controlled closely from the center. He referred to both Japan and Singapore as models, under the mistaken impression that detailed guidance by the Japanese Ministry of International Trade and Industry was responsible for Japan’s successful postwar development, and by Lee Kuan Yew for Singapore’s success. Those models appealed to Jiang because they would enable the central government to play the leading role and retain its power and importance while using market mechanisms to achieve growth and prosperity.” (*Two Lucky People* p. 556) [↑](#footnote-ref-24)
25. The strength of this point depends in part on one’s view of pre-communist China. Dikötter argues that, at least prior to the Japanese invasion, China was making a reasonably successful transition to a market society along western lines and that the widely accepted contrary view was largely due to Communist propaganda against their Nationalist enemies. Dikötter 2008. [↑](#footnote-ref-25)
26. Yan Sun 2004. [↑](#footnote-ref-26)
27. Yan Sun 2004, p. 107. [↑](#footnote-ref-27)
28. Yan Sun 2004, p. 149. [↑](#footnote-ref-28)
29. A third possible strategy would be to perform well and honestly at the lower level in order to be promoted to authority over a large region with greater opportunities for corruption. [↑](#footnote-ref-29)
30. A practice not limited to Chinese officials. It is widely claimed that civil forfeiture in the U.S. functions largely to generate revenue for law enforcement. For an early (fictional) example of the similar use of traffic fines, see the Rudyard Kipling short story “The Village that Voted the Earth Was Flat.” [↑](#footnote-ref-30)
31. Banfield 1978. [↑](#footnote-ref-31)
32. “May be” because one can view the legal system as itself reflecting a form of trial and error development, although it is less clear in that case than in the case of firm design to what degree the mechanisms select for what works. [↑](#footnote-ref-32)