

Economic analysis of China's marketization process over four decades and the construction of the Chinese model and Economics with Chinese Studies

Ruilong Yang

*School of Economics, National Academy of Development and Strategy,
Renmin University of China, Beijing, China*

Abstract

Purpose – Over the past four decades, China has strived to make the market mechanism play a decisive role in resource allocation under the conditions of adhering to the basic socialist economic system. The paper aims to discuss this issue.

Design/methodology/approach – On this matter, this paper proposes a three-phase transition hypothesis for the Chinese institutional change models, namely, a *de facto* path, which gives potential to a successful incremental transition of a centralized country from planned economy to a market economy, lies in the incremental transitions of the institutional change models from a supply-oriented model at initial reform to a middle-proliferation model and to a demand-induced model along with the gradual establishment of exclusive property rights, thereby completing the transition to a socialist-market-economic system.

Findings – The Chinese economic model's unique connotation is the reason why the solution to this model often baffles both the traditional political-economic logic and western mainstream institutional change theory.

Originality/value – This hypothesis corroborates that China's unswerving practice of economic reform has provided unprecedented opportunities and challenges for the development of economic theory. The Chinese model constitutes the source of innovation for the subject of Economics with Chinese Studies.

Keywords Socialist-market-economic system, Institutional change, Chinese model, Chinese economics

Paper type Research paper

1. Introduction

The prototype for the analysis of traditional political economy based on the highly centralized economic system is Stalin's book *Economic Problems of Socialism in the U.S.S.R* (Stalin, 1952). Traditional political economy limits research objects to production relations wherein ownership is a focus and emphasizes the need to expedite the escalation of the ratio of public ownership of production materials. The state allocates resources as much as possible, implementing mandatory plans to restrict commodity–currency relations and limiting or even excluding the principle of material interest stimulus. Egalitarian distribution is implemented. Under the traditional system, the economic inefficiency, distortion of the economic structure, serious bureaucracy, frequent shortages, low labor enthusiasm and other drawbacks have caused serious repercussions on the paradigm of traditional political-economic analysis and strengthened our determination for reform.



After the third plenary session of the Eleventh Central Committee of the Chinese Communist Party, China initiated a historic reform. Over the past four decades, China has undergone an important economic transformation through its reform and opening up strategy. The first is marketization, i.e., the transition from a traditional centrally planned economy to a socialist-market-economic system. The second is industrialization, i.e., the transition from being a traditional small-scale peasant economy to a modern industrial one. The third is internationalization, i.e., the transition from a traditional closed economy to an open one that is incorporated into the process of globalization. The fourth is urbanization, i.e., the transition from an agricultural society to a modern urban one. There is no doubt that marketization is the main line of economic transformation. The focus of reform has been to continuously improve the role of market mechanisms in resource allocation.

With the continuous deepening of reforms, the stance of China's economic community has shifted from being skeptical of the traditional political economy paradigm, to one where China learns from Eastern European economic results with centralization and decentralization as the mainstay elements, and then to the widespread popularity of mainstream western economic systems. We have found that traditional political economy cannot explain why it is necessary to give a decisive role to the market mechanism in the allocation of resources under socialist conditions, while the western mainstream economics cannot explain how to adhere to a basic socialist system under the conditions of a market economy. Although western mainstream economics and traditional political economics are two completely different theoretical systems, they are almost identical in their view of the incompatibility between socialism and the market economy; only logics in argumentation differ. Western mainstream economics believes that exchange is essentially a transaction of property rights. Without private property rights, there can be no real market. Without a market, it is impossible to form equilibrium prices. Therefore, the socialist economy cannot leverage market mechanisms to allocate resources efficiently. Traditional political economy, however, regards the market economy as a patent feature of capitalism. It embraces the doctrine that the public ownership of production materials eliminates the contradiction between individual labor and social labor, and thus the commodity–currency relationship automatically dies out. The market economy will naturally withdraw from the historical stage.

In the past four decades, China has been striving to build a socialist-market-economic system, i.e., striving to make the market mechanism play a decisive role in resource allocation under the conditions of adhering to a basic socialist economic system. This is a great practice that has never been seen before. The Chinese path has accomplished remarkable achievements, both in terms of China's comprehensive national strength and people's living standards. Obviously, practice has gone far before the theory, but the phenomenon of the disjunction between popular economic theory and practice remains quite serious. China's marketization process features not only an important institutional change, but also an important transformation of its economic analysis framework. With a deepening of the marketization process, it has now become the historical responsibility of economic researchers to construct an economic analysis framework and paradigm that are compatible with the real economy.

2. Non-compatibility of the mainstream institutional change model from the west on China's reform

From the perspective of resource allocation, the marketization process from the planning system to the market system denotes a change from hierarchical rules to property right rules. Under the traditional planning system, resource allocation adheres to hierarchical rules. We construct a pyramid-level hierarchical structure, define the position of each agent in this hierarchical structure and further define the resource allocation power that is appropriate to

this hierarchical position. That is, the higher the agent's rank, the greater the power of resource allocation. In the market economy, resource allocation adheres to the property rights rules. In other words, the extent of an agent's resource allocation power is positively related to the quantity and quality of the assets he or she owns. The higher the quality and efficiency of assets, the greater the power of resource allocation will be. Market economy indicates an economy in which the market mechanism has a fundamental role in resource allocation. The key to the market mechanism is that there are market entities with clear earnings expectations that are related to the flexibility of their budget constraints, which, in turn, are related to the clarity of property rights. Therefore, under the conditions of market economy, it is crucial that property rights are clarified to improve the efficiency of resource allocation.

From economic perspective, to explain which model is best suited for a transitional country to complete the transition from hierarchical rules to property rights rules, popular western mainstream institutional economics believes that radical rip-and-replace reforms should be adopted. In accordance with the interpretation of the new institutional economics, institutions whose primary role is to reduce uncertainty by establishing a stable, yet not necessarily effective, structure for human interaction denote an artificial set of rules for determining people's mutual relations. These relations can be divided into constitutional order, institutional arrangements and ethical norms of behavior. The most important function of such institutions is to establish basic economic order for competition and cooperation by constraining individual behaviors that pursue the welfare of the entities or the benefits of utility maximization. Institutional change indicates the processes of substitution, transition and transaction of institutions. Under a decentralized decision-making system based on private property rights, institutional changes are usually triggered by the needs of a person or group resorting to transformation to seek benefits that are not attainable under the existing system. Therefore, the new institutional economists represented by Douglass C. North generally focus on studying institutional changes from the perspective of demand. The demand-determinant model of institutional change assumes that a single agent pursuing profit maximization always seeks to establish the institutional arrangements and definition of rights that are expected to be in their interests under the given constraints. When the agent discovers the net benefits of creating and utilizing the new institutional arrangements are positive, there is a need for institutional change. Whether such demand can induce new institutional arrangements depends on whether the group of agents that approves, supports and promotes such institutional changes is dominant compared with the power of other stakeholders. If it is obvious that they have the advantage in terms of strength advantage, the original institutional arrangements will be eliminated. The state will then establish the property rights rules that are favorable to the dominant agents through laws and other forms, leading to institutional changes. The demand of agents for institutional innovation is motivated by divers factors such as the relative prices of production factors and products, constitutional order and changes in technology and market size (North, 1994).

According to the western mainstream institutional change model, the key behind the transition to the market system is the creation of institutional conditions for the allocation of resources for the market mechanism by establishing property rights rules. However, the state-owned enterprise system and political centralization are the biggest obstacles to the clarification of property rights. Therefore, based on the neoliberal logic, the "prescription" is to follow the "Washington Consensus" and implement radical reforms, namely, the democratization in politics, privatization of state-owned enterprises in the economy and adoption of shock therapy in economic policies. China does not proceed from *a priori* theories but prefers a market-oriented reform not spontaneously driven by profit-seeking micro-agents. Based on China's specific national conditions, a reform model combining top-level design with trial-and-error ("crossing the river by feeling for the stones") has been

adopted for top-down implementation through executive orders, laws and regulations under the organization, and leadership of the central power (Communist Party of China's (CPC) Central Committee, the State Council and other national authorities). The model possesses the following characteristics. First, it leverages existing organizational resources to promote market-oriented reforms, that is, it organizes such reforms through leaders in the original hierarchical structure and gradually reduces the role of hierarchical rules in resource allocation in the process of gradually expanding the market mechanisms. Second, the incremental reform seeks to promote market-oriented reforms at the margin without assuming the lead in partaking in the stakes. Third, the model pilots and then promotes; in particular, reform experience is accumulated in the local scope, and the experience is promoted on a larger scale.

In this paper, the author refers to this kind of compulsory top-down institutional change from the power center as the supply-led institutional change model (Yang, 1993), which generally has the following characteristics. First, in the social game of institutional arrangements wherein government entities and micro-agents participate, the government entities constitute the dominant force that determines the direction, speed, order and mode of institutional change. Second, government entities rely on administrative orders, legal norms and interest incentives to plan, organize and implement institutional innovation from top to bottom within a pyramid-like hierarchical structure. Third, actual institutional changes can only occur when the institutional benefits of the power center outweighs its costs. Fourth, under the condition of uncertainty and insufficient institutional supply, to control risks, the power center sets strict entry barriers for institutional innovation, such as the right for reform pilot, which is similar to priority. In this model, the ability and willingness of the power center to provide new institutional arrangements constitute the dominant factor determining institutional changes. Many factors influence the willingness and ability of the power center system; however, the most important factor is the constitutional order, which defines the orientation and form of specific institutional arrangements through clear regulations on the political system and the basic economic system. Thus, the specific institutional arrangements cannot exceed the institutional innovation space clearly defined by the constitutional order. Besides construction order, the institutional supply cost is another important factor that constrains the willingness and ability of the power center to supply institution.

On the basis of the logic of the western mainstream institutional change theory, such a market-oriented reform promoted top-down approach from the power center will face inherent conflict between the target and the model of institutional change. For China's institutional change, the objective is to ensure that the market mechanism plays a decisive role in resource allocation, and thus, property rights rules should be implemented. However, the supply-led institutional change approach adheres to the hierarchical rule. That is, the institutional innovation has to be implemented from top to bottom through the vertical subordinated administrative system, and inevitably, internal conflicts occur between the hierarchical rules and property rights rules. As a result, decentralization of the government's decision-making power – administrative decentralization or economic decentralization – will gradually disintegrate supply-led institutional changes. To avoid this disintegration, a hierarchy must be maintained and the pace of decentralization should be slow. First, with the advancement of decentralization or reform, the authority has a tendency to diffuse. Second, regarding the diffusion of authority, the hierarchical system of vertical subordination has relaxed, that is, the hierarchical rule of traditional one-way dependence has evolved into a two-way-dependent principal-agent relationship. Third, with the decentralization of the decision-making power, the interest-independent micro-agents will "vote with their feet" and deviate from the track of organized institutional change. Fourth, the direct consequences of decentralized authority are, to a certain extent, the

introduction of property rights rules and market mechanisms. The conflicts between the relaxed hierarchical rules and the unsound property rights rules will definitely lead to chaos in the market order.

Following the logic of the western mainstream institutional change model, under the supply-led institutional change model, incremental reform by itself cannot create sufficient conditions for stock market reform (Yang, 1994). First, incremental reforms do not necessarily diminish the social costs of further reforms and may pose even greater resistance against reforms under certain conditions. The dual system's long-term coexistence has the potential to intertwine old and new vested interest groups, resulting in an upswing of friction costs and inefficient allocation of resources. Second, incremental reforms are not sufficient to change the competitive pattern of established political powers that can determine the strength and direction of stock reform. Third, the institutional increment may be further away from the chosen institutional goals under optimal efficiency. Although, in the initial stage of market-oriented reform, the supply-oriented institutional change model plays a significant role in timely promoting reforms at a relatively low cost, it is bound by hierarchical rules and subject to some insurmountable obstacles regarding the transition to a market economy. The economic obstacle is manifested in the serious inflation triggered by the decentralization reform under government control, and the political obstacle is manifested in the disintegration (due to the decentralization reform under the control of the government) of the hierarchical system that serves to preserve the government authority. When confronted by both the economic and political obstacles, the power center will face a dilemma.

3. Reality-oriented case study: the special role of local governments in China's marketization process

According to the logic adopted by the neo-institutional economics, the supply-led institutional change model, fettered by the economic and political obstacles, will eventually hamper the reform. However, in reality, the marketization process in China has been continuously increasing. So, the following question arises: when top-down reforms face obstacles, which stakeholders play the role of the "first action group" in market-oriented reforms? This question can be answered by reviewing the author's case study of the self-funded economic and technological development zone in Kunshan, Jiangsu. After implementing the fiscal system of "divided income and expenditure, and classified contracts for local and central government" in Jiangsu Province in the early 1980s, the Kunshan Municipal Government, with gradually liberalized economic interests, established a self-funded economic and technological development zone without the authorization of its superiors to attract investment and stimulate micro-agents to create profits (Zhang, 1999). Generally, the establishment of the development zone undergoes the following stages: from the development of horizontal economic associations to the creation of self-funded economic and technological development zones; from the self-funded development zone to being included in the key economic and technological development zones of Jiangsu Province; from the provincial key development zone to one officially approved by the State Council; Economic and Technological Development Zone; and from the "state approval" development zone to the competitor for institutional innovation access.

With the existing theoretical analysis framework, we cannot answer the following questions: Why did the Kunshan Municipal Government officials take the political risk to create a self-funded development zone without the authority of the superior? How does the Kunshan Municipal Government break through the entry barriers of institutional innovation? Why does the higher level of government tolerate Kunshan City to create its own self-funded development zone? Through case analysis, the author discovers that there is a significant relationship between the implementation of the financial contracting system and the changes in local government behavior.

Under the traditional planning system, China implemented a fiscal system with unified state control over income and expenditure, wherein the local government, as an administrative agent, would continuously have to expand its budget by bargaining with the central government and complete administrative goals set by the higher authorities. After the implementation of market-oriented reforms, to mobilize the enthusiasm of local governments, a fiscal system was implemented to divide revenue and expenditure between the central and local governments, holding each responsible for balancing their budgets. The budget of the local government primarily depends on the following two factors: the scale of fiscal revenue associated with the level of local economic development and the proportion of central and local sharing of fiscal revenue. Given that the share ratio has been predetermined by one-on-one negotiations and will remain unchanged for five years, the size of the budget that the local government can control is positively correlated with the total output level of the local society. After the implementation of the fiscal-contracting system, the behavior of local governments changed, and the system formed a unique competition model in China, that is, competition between local governments over GDP, which has become the most important metric. Developing local economy has become a strong impetus for local government officials, who have become political entrepreneurs. They operate in the political system but seek political promotion through the pursuit of local economic development. With the change in behavior patterns, local governments are motivated to pursue rapid local economy growth and respond to profit opportunities for institutional innovation.

Local governments independent of economic interests have the incentive to create an environment conducive to the local economic development through institutional innovation, but this innovative demand is not easily satisfied. Under the condition of vertical allocation of reform rights, higher level of governments usually formulate institutional innovation schemes based on the dual goals of total social output maximization and monopoly rent maximization. Moreover, to promote reform, they prefer to choose an unbalanced reform strategy that uses existing organizational resources. Concerning the space for reform, the strategy of “first piloting and then promoting” is adopted. From the perspective of the timetable for reform, incremental reform is advanced to stock reform. Pilot units receiving reform priorities can usually achieve double benefits with small reform costs: first, the additional benefits brought about by preferential policies and second, the institutional benefits brought about by the first-mover institutional advantage. The existence of entry barriers provides these benefits the nature of “monopoly rents.” The necessary condition for obtaining the rents is to obtain the priority of institutional innovation from the higher level of government.

Individuals or enterprises find it difficult to directly break through the entry barriers to institutional innovation set by higher level of governments. They can only indirectly demonstrate their needs through the higher authorities in jurisdiction. Local governments, as administrative agents of vertical institutional arrangements, have both incentives and the ability to bargain with higher authorities for institutional arrangements conducive to local economic development. To pursue economic development, at the time, the Kunshan Municipal Government formed a better investment environment than other places by setting up a self-funded economic and technological development zone; it further expanded the scale of investment attraction, thereby taking the lead in local competition. However, here the following questions arise: when the Kunshan Municipal Government's spontaneous institutional innovation demand is inconsistent with the superior government's initial institutional supply willingness, how does the Kunshan Government break through the entry barrier set by the higher government under the given institutional conditions? Why did the superior government tolerate it at first and then endorse the voluntary institutional innovation activities of the Kunshan Municipal Government? The case of Kunshan City

shows the specific path of the local government's voluntary system innovation. First, "Do it with your mouth shut." To seek institutional arrangements conducive to the development of the local economy, the Kunshan Municipal Government, through lobbying or seeking "relationships," has made the eyes of the "key person" with access to the self-funded development zone of Kunshan half shut, thereby "quietly" breaking through the entry barriers. Second, "Speak after finishing the job." The establishment of the self-funded development zone has greatly enhanced the intensity of promotions related to investments in Kunshan City and stimulated local economic development. With the strengthening of economic strength, Kunshan City began to consciously "speak" the performance of spontaneous system innovation through various channels, hoping to gain recognition from the higher level of government by creating momentum and *fait accompli* and endeavoring to obtain formal access. Third, leadership instructions/inscriptions: from "underground" to "over ground." The superior leadership has a significant role in the formal identification of institutional innovations undertaken by local governments. Therefore, local governments will find ways to let the superiors take a stand in formal or informal situations, such as during submission of reports or local inspections to obtain the superiors' inscriptions and affirmative instructions, for external propaganda to subtly legitimize their activities. To some extent, the inscription or instruction of the superior leader is an informal "property right protection." Fourth, "First raise a son, then get a marriage certificate." Unauthorized Institutional innovations were initially considered "illegitimate children." Despite receiving praise from their superiors or the media, if their "accounts" are unreported, the new property rights rules implemented by them will not be under the protection of the state. Therefore, the local government will post-register the "marriage certificate" through various relationships at the expense of part of the incremental income to obtain the "account" of the "illegitimate child," so that the higher level of government can officially recognize its spontaneous institutional innovation.

The extent to which the higher level of government tolerates and even ratifies the local government's spontaneous institutional innovation behavior depends on, in addition to the local government's ability to negotiate based on economic strength, two other factors. On the one hand, it is related to the degree of authority diffusion. The so-called diffusion of authority refers to the fact that the lower level of government manipulates the authority granted by the higher level of government to perform unauthorized actions. In the top-down institutional change, the implementation cost of formal institutional rules is directly proportional to the degree of authority diffusion. On the other hand, it depends on whether the income obtained by the higher level of government surpasses the cost of maintaining the control of access in the institutional structure, which the local government gradually changes in pursuit of potential institutional benefits. When the local government is willing to pay some of the extra income in exchange for the *ex post facto* ratification, and the higher level of government's cost to protect the old property rights structure outweighs the income from the new property rights rules, the latter will tolerate and ratify the former's institutional innovation activities in pursuit of productive profits.

The case of Kunshan City reveals that the implementation of the decentralization and interest concessions and the "dividing of revenue and expenditure between the central and local governments and holding each responsible for balancing their budgets" in the fiscal system can lead to a local government with greater resource allocation rights that becomes a political organization, while simultaneously pursuing the maximization of economic benefits. The change in the negotiation power elicited by the improvement in the local governments' economic strength has led to efforts to rebuild new political and economic contracts. When the local government with independent interests becomes the intermediary link between the supply willingness of the higher-level government system and the innovation demand of the micro-agent system, it becomes possible for one to break through

the barriers to institutional innovation set by the higher level of government. Thus, an agreement can be reached between maximizing the monopoly rent of the higher level of government and protecting efficient property rights structure. This phenomenon has led to the deepening of the marketization process and is referred to by the author as the intermediate diffusion model of institutional change.

4. Market-oriented reform path with Chinese characteristics and reshaping the dynamic mechanism of reform

The officials of the central government and local governments, as well as micro-agents, play different roles in the stages of supply-led, intermediate diffusion and demand-induced institutional changes, so the system experiences echeloned changes. The central government chose the incremental reform because the problem of insufficient information under the established constraints necessitates the trial-and-error model ("cross the river by feeling for the stones"). The local government's participation in institutional innovation has created a low-cost, low-risk knowledge transfer and accumulation mechanism for the central government, thereby accelerating the central government's ideological recognition of the market economy; and greatly reduced the possibility of the reform becoming an "explosive revolution," making the incremental market-oriented reforms continuous in the interaction of central and local government officials and micro-agents, with Pareto improvement and effectiveness. The role of local governments as active participants in market-oriented reforms has made China's institutional changes moving in a stepwise pattern, weakening the institutional heritage's constraints on progressive market-oriented reforms (Yang and Yang, 2000).

In such reforms, local governments are considered the "first action group" that actively seeks the potential net institutional benefits. For local government officials, their political promotion generally rests with the level of local economic development, so they have the characteristics of entrepreneurs in the Schumpeterian sense. Moreover, local governments face conflicts between maintaining hierarchical rules and introducing property rights rules while implementing institutional innovations. Under fixed central and local fiscal revenue sharing ratios, their goal of maximizing disposable fiscal revenues relies on the realization of the enterprises' goal of profit maximization. However, their goal of maximizing government monopoly rent – primarily manifested as career promotion, power stability, resource manipulation, gray income, etc. – is also closely related to the economic development level of the region, which, in turn, depends on the expansion of the company and the improvement of efficiency. Therefore, to obtain monopoly rents, local governments prioritize efficiency in defining and protecting property rights, thus helping to resolve conflicts between the two rules.

Under the condition of promoting the market-oriented reform through administrative decentralization and interest concessions, market competition first manifests itself as competition between localities and then as competition among enterprises. By virtue of their administrative power and economic strength, local governments will strive to help local enterprises to attract scarce resources from the outside and help promote local products. This kind of market competition behavior of local governments has dual characteristics. On the one hand, it has a local protectionist tendency, especially when the locality is at a distinct competitive disadvantage and cannot push through the access barriers to institutional innovation set by higher level of governments. On the other hand, it will leverage various policies to create a preferential investment environment and be willing to define and protect property rights and attract the inflow of resources.

To attract more resources in competition and stimulate local economic development, aside from requiring superiors to provide preferential policies, local governments also have the motivation to build a relatively efficient property rights structure by breaking through

the access barriers to institutional innovation. A move is expected to attract foreign capital and domestic capital inflow through effective property rights protection and ideal investment environment as well as encourage the generation of productive profits by clarifying the investment income expectation of micro-agents, thereby expanding the residual sharing of local governments. When such institutional innovations promoted by local governments help encourage the agents to create productive profits, the interest-seeking activity of special interest organizations or groups in society may not necessarily reduce social efficiency and total income but might lead to Pareto improvements.

Under the condition that the higher level of government controls the access of institutional innovation, although local government and enterprises have disagreements regarding the distribution of the decision-making power and the distribution of residual claims, they have a strong interdependence concerning the methods they use to compete for monopoly rents associated with priority access rights. In this cooperative game, enterprises, with the help of local governments, gain potential institutional benefits by pushing through access barriers, with local governments sharing these benefits. Therefore, this process of cooperation between local governments and enterprises is actually a process of internalizing external profits by clarifying property rights relations. It has promoted the transformation of enterprises into market competition entities that are autonomous and self-financing (responsible for their own management decisions, profits and losses). In the first-mover reform areas, the reform of the enterprise property rights system is always a step ahead, and the ability of enterprises to capture profit opportunities is strong.

When institutional changes transition from command and control to negotiation and coordination, it is likely that local governments will generate dual effects in China's marketization process. First, the monopoly rent brought by the priority access will induce local government's profit-seeking activities. When one place breaks through the access barriers, other places will follow suit. The breakthrough of the barriers to entry and the disappearance of monopoly rents have weakened the once dominant position of the higher level of government in the supply of institutions. It mainly serves as an *ex post* after-the-fact recognition of the institutional innovations executed by local governments and enterprises. Second, the intermediate diffusion process of institutional innovation is the process of establishing exclusive property rights. The internalization of external profits is realized by clarifying the income expectations of the micro-agents; thus, the residual shares of the local governments and enterprises are simultaneously increased. Once a company gains greater autonomy, it endeavors to limit government intervention in its own ability to capture market profit opportunities, including institutional innovation activities. Although local governments are still motivated to control enterprises, with the establishment of exclusive property rights, the cost of government control over enterprises is exorbitantly high, whereas adopting the strategy of *laissez-faire* (govern by non-interference) can both enhance the vitality of enterprises and enable the government to share surplus. From the principle of maximizing profits, local governments will restrict unreasonable administrative intervention. The catchphrase of "smaller government, bigger social well-being" has been purported invariably at a certain stage in the reform of property rights system in some areas with a rapid pace of reform, where the transformation of government functions evidently outpaces other areas where reforms are relatively lagging behind.

Therefore, the author proposes the three-phase transition hypothesis of China's institutional change model, namely, a *de facto* path, which gives potential to a successful incremental transition of a centralized country from planned economy to a market economy. This hypothesis lies in the incremental transitions of the institutional change models from a supply-oriented model at initial reform; to a middle-proliferation model; and to a demand-induced model that is consistent with the inherent requirements of the market economy, thereby completing the transition to a socialist-market-economic system (Yang, 1998).

Under the condition of the access barriers of institutional innovation, the three-phase transition hypothesis of institutional change can better reveal why government-led reform can lead to *de facto* marketization. However, when we assess the market-oriented process led by the government from the perspective of normative analysis, we find that the market-oriented reform with government–enterprise partnership elicited by this institutional change model also causes serious problems. Although the government–enterprise partnership provides a dynamic mechanism for government-led marketization, it also has a series of negative effects, including behavioral anomie, “reasonable but unlawful” or “lawful but unreasonable” acts, rampant corruption, overspread of hidden rules such as “playing edge balls” (rule-bending activities taking advantage of legal loopholes) and capital and labor conflicts. For example, the vagueness of code of conduct of political entrepreneurs leads to a rise in corruption. The blind pursuit of GDP by local government officials leads to the neglect of resources, environment, society and other issues, resulting in the decline of local sustainable development capacity. The intensification of competition between locals leads to local blockades, resulting in the so-called “vassal economy” (i.e. a fragmented regional economy that only deals with local interests) and other phenomena (Yang, 2018).

Due to the emergence of a series of negative effects caused by government–enterprise partnership, coupled with the changes in China’s economic growth conditions and external environment, the local government-led institutional changes are faced with new challenges to. First, government-led reforms have slowed structural adjustments. In the face of the decline in traditional growth factors, the decline in potential growth rate, and the tightening of the external environment, new growth factors should be cultivated, structural distortions must be rectified and the quality of economic growth ought to be improved by implementing innovation-driven development strategy and advancing supply-side structural reform. Given the construction of new growth models, the sustained growth in domestic demand highly depends on market guidance, and government leadership may undermine the restructuring of market-oriented economy. Second, leveraging the original organization to promote reform will encounter increasing resistance. With the development of the economy, the original organization may form alliances with certain market entities, forming a specific interest group, and the driving force for vested interests to continue reform may decline. Third, the implementation space for incremental reforms is decreasing. New incremental reforms are often non-Pareto improvements, and some people are bound to suffer from the loss of benefits in the reform process. The new reform requires binding government power and increasing government transparency, all of which can detrimentally affect the personal interests of the officials. Fourth, the reform model of piloting first and promoting second is difficult to sustain. The reform of the pilot right in the administrative system plays an important role in mobilizing the enthusiasm of the local government’s reform, as the pilot right will bring monopolistic institutional benefits. However, with economic development, the rent-seeking behavior in the wake of such pilots has become increasingly serious, thereby distorting the true cost and benefits of market-oriented reforms.

Recently, we have been resolute in anti-corruption actions against the negative phenomena arising from the government–enterprise partnership which is on the right course. However, since this kind of ironclad anti-corruption has greatly improved the social atmosphere and greatly enhanced CPC’s prestige, the incentive compatibility mechanism between local government officials and entrepreneurs through partnership to compete for reform priorities has changed. Thus, the dynamic mechanism of reform under the leadership of the executive power has relatively mutated. Some local government officials are lazy and neglectful of their duties to evade the risks derived from the reform, outweighing the benefits. The innovation-driven development strategy or improvement of structural quality

through restructuring relies on the deepening of market-oriented reforms. However, the current reforms generally have the phenomenon of “much cry and little wool (much said but little done),” and the root cause still lies in the insufficient motivation for reform. Therefore, after the strategic victory of the anti-corruption campaign, a new round of large-scale reform and large-scale incentive-compatible dynamic mechanism must be established on the basis of stabilizing growth.

The necessary factors to reshape the dynamic mechanism of market-oriented reform are re-clarifying the boundaries of rights between the government and market, establishing a new type of relationship between the government and commerce, and focusing on building a new economic system with “effective market mechanisms, dynamic micro-agents, and appropriate macro-control.” In the process of adjusting interest relations, we will seek the impetus for reform, mobilize the positive factors of all parties and promote the continuous advancement of reform. First, redefining the boundaries of rights between the government and market, the governments shall set boundaries for themselves and resolutely perform their “do’s and don’ts.” The full development of the market economy requires the government to provide corresponding services, and the government must shift from a growth-oriented government to a development-oriented government. Through the government’s own reforms, the traditional interest distribution pattern among the government, enterprises and households will be broken. The functions of the government shall be transformed to avoid the government “contending for interests against the people.” Second, to further deepen the reform of the property rights system, the following three aspects must be included: to further promote the reform of the mixed ownership system of state-owned enterprises under the logic of classified reform (function-based reform), the government must resolutely perform their “dos and don’ts”; the government should develop the private economy and protect private property rights; and the government should deepen the reform of the land system in the process of promoting urbanization. Third, the further improvement of the market system shall focus on the amelioration of the factor price system and the reform of the financial system. The core is the reform of the property rights system of financial enterprises, the marketization of interest rates, the internationalization of the RMB and the independence of the Central Bank. Fourth, economic development must be coordinated with social development to actively promote social reform. Currently, the changes in social structure are primarily manifested as follows. With the development of the network and information dissemination, the perception and pursuits of self-interest are reinforced. The interaction and mutual influence of the interests of members of the society are augmented, shifting from the previous segmentation to become increasingly integrated. The interests of social members are increasingly diversified, and the conflicts of interest of different stakeholders are gradually intensifying, correspondingly requiring diverse and flexible social policies. Thus, economic reforms need to reflect the bottom-up needs of residents, which can better reflect the distribution of residents’ self-interests, the diversification pattern and the flexibility requirements of development. Residents should be encouraged to participate in policy design and feedback on policy practices. At the same time, the entire distribution system must be improved, including initial distribution and redistribution. Moreover, the urban–rural disparity and regional gaps can be minimized through urbanization and regional development policies, and the social security system can then be further improved (Yang, 2014).

5. Conclusion: construction of the Chinese model and Chinese economics

Presently, the achievements of China’s market-oriented reforms are widely being recognized. China’s market-oriented reform is neither a fine-tuning adjustment nor a flag-changing subversion. With a fundamental change to the traditional planning system, it has embarked on a Chinese-style reform path. This Chinese model generally has the following

major characteristics: the reform aims to establish a socialist-market-economic system; the basic institutional framework is to adhere to the ownership structure dominated by public ownership, seeking common development with multiple ownership economies; the economic operation mechanism emphasizes the decisive role of the market mechanism and to enhance the role of the government; the reform method aims to adhere to incremental reforms under the leadership of the Central Committee of the CPC while correctly handling the relationship between top-level design and trial-and-error (“crossing the river by feeling for the stones”); and the environment for reform is to correctly handle the relationship among reform, development and stability.

The “Chinese model,” “Chinese experience” and “Chinese road” are receiving increasing global attention. However, summarizing the general economic theory system from the reform path, the opening up and the development model with distinctive Chinese characteristics is difficult under the existing theoretical analysis framework and logic. The theory is gray; however, the “tree of life” is evergreen. The so-called theory refers to the systematic conclusions about the knowledge of nature and human society summarized by practice. It has important enlightenment and reference value for future practical activities. However, given that practice itself is constantly changing, it is imperative for the theory to innovate accordingly and timely. Theory of true vitality does not refer to the pure speculative logic from books to books and from concepts to concepts but to the theoretical crystallization that comes from practice, returns to practice and is proven to be correct by practice. Many of problems raised by the practice of reform and opening up clearly cannot find a solution from off-the-shelf theoretical works. China’s reform path can find the answer in neither the traditional political-economic logic nor western mainstream economics. The analysis paradigm based on social person hypothesis and holistic class interest analysis can hardly deduce that the market mechanism shall play a decisive role in resource allocation under socialist conditions. The analysis paradigm based on the economic man (*Homo Economicus*) hypothesis and the individualist cost–benefit analysis can hardly deduce the basic socialist institutional characteristics under the market economy, such as public ownership and people-oriented economy.

China’s reform experience tells us that it is dangerous to blindly reproduce the individual “conclusions” of the classic Marxist authors or the theorems of western economics. Therefore, we should step out of the legacy mindset and break through previous theoretical frameworks and dogmas, and face reality based on practice, emancipating the mind, testing and developing existing theories through in-depth analysis of phenomena, and actively promoting the innovation of China’s economic research paradigm. Theoretical innovation needs to adhere to the reality-oriented and problem-oriented research attitude and methods. When a conflict arises between theory and practice, it is beneficial to link the theory to practice rather than adapting practice to theory. Reality-oriented research does not imply that theory should be done away with, but it implies that the research should start with the special phenomena arising from China’s economic reform and economic development, as well as test the existing theory through in-depth analysis of the phenomena. If the existing theory is insufficient to answer the implied question, we need to reflect on the theory itself until we amend the theory according to reality. The great practice of China’s reform has provided unprecedented opportunities and challenges for the development of economic theory. The Chinese model and the Chinese path are the sources of innovation for the subject of Economics with Chinese Studies. Under this circumstance, China’s economics discipline should be constructed by summing the experience of China’s economic reform and economic development, theoretically and scientifically answering a series of new questions raised in the new historical stage, promoting the innovation and development of economic theory, and striving to construct and develop a theoretical economics system using Chinese characteristics, manner and style.

References

- North, D.C. (1994), *Institutions, Institutional Change and Economic Performance*, Shanghai Joint Publishing Company, Shanghai.
- Stalin, J.V. (1952), *Economic Problems of Socialism in the U.S.S.R*, People's Publishing House, Beijing.
- Yang, R. (1993), "On institutional supply", *Economic Research Journal*, Vol. 28 No. 8, pp. 45-52.
- Yang, R. (1994), "On the conflict and coordination of china's institutional change model and institutional choice objectives", *Economic Research Journal*, Vol. 29 No. 5, pp. 40-49.
- Yang, R. (1998), "The three-phase theory of the transition of institutional change model in China – also on the institutional innovation behavior of local governments", *Economic Research Journal*, Vol. 33 No. 1, pp. 5-12.
- Yang, R. (2014), "Structural foundation and policy choices for sustainable domestic demand growth in China", China Renmin University Press, Beijing.
- Yang, R. and Yang, Q. (2000), "A model of stepwise gradual institutional changes – a re-discuss of local governments' functions in institutional changes of China", *Economic Research Journal*, Vol. 35 No. 3, pp. 24-31.
- Yang, R. (2018), *The Economic Theory of Socialism*, 3rd ed., China Renmin University Press, Beijing.
- Zhang, S. (1999), *Case Study of China's Institutional Change*, Vol. 2, China Financial & Economic Publishing House, Beijing.

Corresponding author

Ruilong Yang can be contacted at: yangruilong@263.net