How China Became Capitalist
Ronald Coase and Ning Wang
Palgrave Macmillan, 2012, 256 pp.

In 1981, shortly after China began to liberalize its economy, Steven N. S. Cheung predicted that free markets would trump state planning and eventually China would "go 'capitalist'." He grounded his analysis in property rights theory and the new institutional economics, of which he was a pioneer. Ronald Coase, a longtime professor of law and economics at the University of Chicago and Cheung's colleague during 1967–69, agreed with that prediction. Now the Nobel laureate economist has teamed up with Ning Wang, a former student and a senior fellow at the Ronald Coase Institute, to provide a detailed account of "how China became capitalist."

The hallmark of this book is the use of primary sources to provide an in-depth view of the institutional changes that took place during the early stages of China's economic reforms and the use of Coaseian analysis to understand those changes. In particular, Coase's distinction between the market for goods and the market for ideas is applied to China's reform movement and gives a fresh perspective of how China was able to make the transition from plan to market. The key conclusion is that the absence of a free market for ideas is a threat to China's future development.

The book has six chapters and an epilogue. It begins with an account of China at the time of Chairman Mao Zedong's death in September 1976, and then examines the transitional period during 1976–78, the rise of Deng Xiaoping, the "marginal revolutions" during 1978–88, the reversal after the 1989 Tiananmen crackdown, and the restart of the economic reforms in 1992, signaled by Deng's famous "Southern tour."

During the first decade of reform, the rise of the nonstate sector—motivated by the terrible costs inflicted on the Chinese people (especially peasants, entrepreneurs, and intellectuals) by Mao's Great Leap Forward (1958–61) and the Cultural Revolution (1966–76)—was characterized by four "marginal revolutions."

First, private farming (the "household responsibility system") arose to replace the state-run communes that had led to mass starvation. Poor farmers in small villages began the market revolution, not planners in Beijing. Local officials, however, played an important role in giving rural households more autonomy, allowing them to sell their produce on the open market after meeting a state quota. Productivity increased and farmers began to reinvest their profits, which led to the second marginal revolution: the emergence of township and village enterprises. The TVEs released entrepreneurial energy that had been suppressed under the old regime, helped transform the countryside, and spurred industrialization. Both reforms sprung from the bottom up; there was no central blueprint. Local private parties and officials pushed for institutional changes that would allow more freedom and more choices. When local market experiments were successful, central authorities sanctioned them—and the masked reforms became transparent and spread.

Two further marginal revolutions occurred with the rise of private (individual) businesses in urban areas and the approval of Special Economic Zones in Guangdong and Fujian. The opportunity to be self-employed and entrepreneurial outside the state sector, and the liberalization of international trade in SEZs, allowed new markets to emerge and new wealth to be created. The idea was to "save socialism" by permitting "capitalism." But the momentum unleashed by allowing markets to develop and the profit motive to emerge was too powerful to reverse. Shenzhen, the first SEZ, was a small fishing village in 1978. Today it is a booming commercial city with more than 30 million people, and China is the largest exporter in the world.

While the marginal revolutions were taking place during 1978–88, a second track of reforms took place under the top-down, state-led development model. However, rather than follow the Stalinist-type approach, reformers incentivized state-owned enterprises by allowing managerial contracts that were linked to profits. But price controls, subsidies, and investment planning still dominated the landscape with funds primarily directed to SOEs in the heavy industrial sector. Those legacies of Soviet-style central planning contrasted sharply with the growing economic freedom outside the state sector.

The contradictions in China's market socialist system emerged in force with a serious inflation that reached nearly 20 percent in 1988, which led to unrest and helped fuel the May-June uprising in Tiananmen Square. The ouster of Zhao Ziyang and other Chinese liberals led to a major debate over the direction of future reform. Deng Xiaoping kept the flame of economic freedom burning and reform returned in 1992 following his Southern Tour, which began in Shenzhen. China's long march toward the market, initiated by the four marginal revolutions in the 1980s, was to continue.

The "second economic revolution" began with price reform in 1992. By the end of 1996 "dual-track" pricing, which had allowed the development of market prices alongside state-controlled prices, ended. Under the dual-track system there was much mischief, but that system did allow officials the space to move toward full-market pricing. In 1994, there were significant changes to the tax system, with simplification and a more uniform tax-sharing scheme, ending the complex negotiations under the previous regime, in which prices were severely distorted. Finally, in the mid-1990s, there was substantial privatization of small and medium-sized SOEs, which imposed a hard budget constraint on firms.

Those market-friendly reforms led to the creation of a national common market and the demise of regional protectionism. Indeed, Coase and Wang point to the emergence of regional competition as a key factor in fostering the market for ideas (through a Hayekean discovery process), as local officials experimented with new institutional/property rights arrangements and sought to promote economic growth rather than ideology. The slogan, popularized by Deng, was "It doesn't matter if a cat is black or white, as long as it catches mice."

Areas that adapted to the market-led model of development prospered and trade flourished, especially in the coastal regions. The dynamic aspects of the gains from trade were evident as millions of people lifted themselves out of poverty, gained new ideas from exposure to the outside world, and experienced greater choices and more freedom. Because of trade liberalization, the markets for goods and ideas expanded.

Under Mao private enterprise was outlawed and foreign trade nonexistent. The "Great Helmsman" limited the search for truth to his "Little Red Book." He sent scholars (the "stinking ninth class") to the countryside and closed schools, supressing the market for ideas. He ignored the Confucian tenet of "seeking truth from facts" and the ancient Chinese adage to "let 100 schools of thought contend." The collectivization of agriculture destroyed the learning process that naturally occurs under private ownership and dulled incentives to innovate.

The Chinese Communist Party still has a monopoly on power and supports it with tight control over the market for ideas. Nevertheless, China has made great progress in opening its economy to competition, and people have much more economic and personal freedom than under Mao. The authors rightly point out that the lack of freedom of thought harms China's educational system as well as its economic system, and deprives individuals of a fundamental human right. Yet Coase and Wang are cautiously optimistic about China's future.

The CCP has mostly abandoned its adherence to crude Marxism and class struggle, which characterized the Maoist regime. The market is now recognized as an important component of China's socialist system, and limited private ownership is sanctioned. Deng's mantra that "to get rich is glorious" and his pragmatic approach to reform have persisted. The authors understand that China is far from a free society and that its form of "capitalism" is culturally conditioned and inconsistent with what Milton Friedman called "free private markets." Nevertheless, China has moved a long distance from Mao to the market, and the authors contend that it is more fruitful to think of what needs to be done to advance the market for ideas than to dream of making China a democratic nation. They do not disparage democracy, but argue that limiting the power of government and increasing the range of choices open to people are the necessary first steps toward a harmonious and prosperous future for the Chinese people.

China should draw on its own culture and "seek truth from facts." Denying citizens the right to freely exchange information and search for the truth, which means being allowed to criticize the CCP, can only harm future progress. The authors are correct in concluding that "when the market for goods and the market for ideas are together in full swing, each supporting, augmenting, and strengthening the other, human creativity and happiness stand the best chance to prevail."

The lack of transferable land rights, the massive rent seeking and corruption that characterizes China's political economy, the *hukou* system of urban registration that is both inefficient and unjust, the financial repression and lack of capital freedom that narrowly limit investment choices, and the lack of a transparent and effective legal system that protects both economic and personal freedom present opportunities and challenges for further reform. Indeed, according to the authors, "The lack of a free market for ideas . . . has become the most restrictive bottleneck in China's economic and social development."

To overcome the obstacles to further reform, one must understand China's past and consider the impact of institutional change on incentives and behavior. Coase and Wang's scholarly and pragmatic book will help in that effort. Its concise analysis, extensive notes, and numerous references will be of great value to both experts and novices in the search for "truth from facts."

I have greatly benefited from this book, but I do have a few quibbles. First, the authors admit that the word "capitalism" means different things to different people and that using it without a qualifier for China could be misleading. Thus, the term "capitalism with Chinese characteristics" may be more appropriate. Of course, the term China's leaders would prefer is "a socialist market economy with Chinese characteristics."

The word "capitalism" is emotive and widely misunderstood. Using it in the book's title causes some problems. The correct meaning of capitalism, as Armen Alchian pointed out, is the ability to capitalize future income streams into their present values by having the right to private property, which allows the exchange of rights and effective claims to profits. In this sense, capitalism is an incentive system designed to make individuals responsible for their actions and is the foundation for free markets. China's system is better described as "crony capitalism." There is a lack of well-defined private property rights, including the lack of a free market for ideas. In 1988, at the Cato Institute's conference in Shanghai, Cheung (who was Alchian's student) argued that "a general problem calls for a general solution," and emphasized that China needed to "privatize state enterprises and allow free entry for all." After 25 years, those goals are yet to be realized.

Second, the authors correctly argue that culture and informal rules play an important role in shaping economic and social systems, and that a sense of justice is important in the pursuit of happiness. They note that, unlike most leaders around the world, former premier Wen Jiabao read Adam Smith's *The Theory of Moral Sentiments*, and they distinguish between Wen's perception of equality and Smith's. I would have liked to see a further elaboration of that distinction, which Wen never fully understood or accepted. In particular, Smith's concept of justice as the prevention of injustice and the protection of fundamental rights to life, liberty, and property needs to be heard. If private property rights were respected, the CCP's monopoly on power would end. Coase and Wing, of course, recognize that as the market for ideas expands, liberty and justice will advance—and civil society flourish.

Third, the authors criticize Leszek Balcerowicz, Poland's former deputy prime minister and a pivotal figure in the post-communist transition, for saying, "We are too poor to experiment." He did not follow China's experimental approach because he wanted to undertake *radical* change and rely on "proven models." His "shock therapy" allowed Poland to move quickly from central planning to an open-market system and undermined vested interests. Unlike China, in which the Communist Party still rules, Poland exited the Soviet bloc, abandoned communism, and pursued its own path. China, of course, faced different constraints and chose to follow a different transition path, relying on gradualism and trial and error.

Finally, it would have been useful for the authors to use subheads in their lengthy chapters rather than roman numerals, and to include some tables with timelines to help readers keep track of the complex array of reforms, and to use a few charts to convey economic trends before and after key reforms.

These minor points, however, do not distract from the brilliance of this book. It is also noteworthy that, in the Confucian tradition of teacher and student, Ronald Coase, who has passed the centennial mark, has imparted his wisdom to Ning Wang, an energetic and able scholar without whom this book could not have been written. He was instrumental in researching primary sources and in bringing to notice ancient Chinese texts such as the *Book of Shang*, which recognized the importance of just laws and a clear legal framework in bringing about social harmony:

> When rights and duties are indefinite, even men like Yao and Shun will become crooked and commit acts of wickedness, how much more then the mass of the people! This is the way in which wickedness and wrong-doing will be greatly stimulated, the ruler . . . . will ruin his country and bring disaster upon the land and its people.

Under Mao there was no law and no clearly defined property rights. The result was chaos and destruction. Since the liberalization movement began in 1978, China is slowly moving toward a genuine rule of law, but there is much to be done if Wen's goal of having "the Chinese people live with more happiness and dignity" is to be realized.

The rise of private think tanks in China, such as the Unirule Institute with its market-liberal leader Mao Yushi, who was awarded the Milton Friedman Prize for Advancing Liberty in 2012 by the Cato Institute, should please the authors, as should the rapid advance of social media. Chinese bloggers, known as "citizen reporters," are challenging old concepts and creating new ways of thinking about the relation between the individual and the state. People are demanding greater freedom of expression and are more interested in improving their living standards than in advancing socialism. The "Great Firewall" may slow the information revolution, but there is much room for optimism. The establishment of the Ronald Coase Center for the Study of the Economy at Zhejiang University is one sign of hope for the future of China.

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