

THE POWER OF IDEAS AND LEADERSHIP IN CHINA'S TRANSITION TO A LIBERAL SOCIETY

Weiying Zhang

History and casual observations suggest that ideas and leadership are the two most important forces in all institutional changes. However, they have been absent or downplayed in conventional economic analysis of institutional changes. Conventional economics has exclusively focused on the notion of “interest” in explaining almost everything, from consumers’ choices to public choices to institutional changes. In particular, institutional changes have been modeled as a game of interests between different groups (such as the ruling and the ruled), with the assumption that there is a well-defined mapping from interests into outcomes.¹

In this article, I argue that this perspective of institutional change is fundamentally problematic because any institutional change cannot be well understood without taking into account two crucial factors: (1) ideas about the direction of the institutional change and (2) leadership under which the institutional change takes place. I will analyze China’s economic and political transition to a liberal society

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Weiying Zhang is Sinar Mas Chair Professor of Economics at the National School of Development, Peking University. This article was first presented at the Mont Pelerin Society’s 2014 General Meeting in Hong Kong.

¹See Acemoglu and Robinson (2006), among others. The work of North, Wallis, and Weingast (2009) is among a few exceptions that incorporate ideas (beliefs) into the analysis of institutional equilibrium.

by taking these two factors into account, explaining what happened in the past 35 years of the reform and predicting what will happen in the future.

I will analyze how ideas and leadership influence institutional change by adopting a simple two-dimensional framework. Ideas can be right or wrong. Leadership can be strong or weak. Thus, there are four combinations: right ideas with a strong leadership, right ideas with a weak leadership, wrong ideas with a strong leadership, and wrong ideas with a weak leadership. To facilitate the institutional changes into the right direction, the best combination is right ideas with a strong leadership; while the worst one is wrong ideas with a strong leadership. For example, Mao Zedong was a strong leader, but had wrong ideas about China's economic and social development, which led to a great disaster for the Chinese people during the period from 1949 to 1976. On the other hand, the success of China's economic liberalization since 1978 could very much be attributed to the right ideas and strong leadership of Deng Xiaoping and his successor Jiang Zemin. Deng and Jiang both had a somewhat strong belief in the market mechanism and entrepreneurship. They both were strong leaders to put forward their reform programs. However, Hu Jintao's regime from 2003 to 2012 was characterized with the combination of wrong ideas and a weak leadership. During this time, China's reform stagnated while many serious social problems emerged.

One plausible explanation for former president Hu's weak leadership is the path he went through in becoming president. He was the product of the Chinese political bureaucratic system, which is incapable of producing strong leadership required to embark on bold political changes. On the other hand, the new leaders of China, particularly President Xi Jinping, are not the direct products of the existing political bureaucratic system, due to their elite family backgrounds. As a result, they might be less constrained by such a system but are more entrepreneurial, having a clearer sense of mission, courage, and ability to lead. I thus believe that the next decade under President Xi's leadership presents a unique window of opportunity for China to make important institutional changes. China must not miss that opportunity.

The future of China's transition to a liberal society is dependent on the new leaders' ideas and leadership. Currently, China is trapped into six wrong ideas: (1) China's economic success in the past three decades comes from the "China model"; (2) economic success can

continue without political reform; (3) current institutions benefit vested interests and any reform would harm those interests; (4) state-owned enterprises (SOEs) are the economic cornerstone of the Chinese Communist Party; (5) “political power comes from the barrel of a gun”; and (6) the more power government holds, the stronger it will become. I will elaborate on how wrong these six ideas are and why the new leaders must get rid of them in order to sustain China’s economic success.

This article is organized as follows. In the next section, I will articulate why ideas and leadership are important in understanding institutional changes. Then, I will present a two-dimensional framework to discuss the effects of the four combinations of ideas and leadership on institutional changes. Following that, I will discuss how the ideas and leadership combinations manifested themselves in the first 25 years of the economic reform under Deng and Jiang’s regimes (from 1978 to 2002), and under Hu’s regime (from 2003 to 2012). I will then discuss the idea traps and the leadership challenges China faces today. Lastly, I will conclude by proposing how important it is to create an ideas market in advancing China’s economic progress and in transitioning China into a liberal society.

The Importance of Ideas and Leadership

More than a century ago, the British economist Francis Edgeworth (1881) claimed that “the first principle of economics is that every agent is motivated only by self-interest.” Edgeworth’s claim succinctly summarized the fundamental assumption underlying the conventional economics that is still dominant today—that is, as rational agents, individuals know their interests and attempt to maximize them. Thus, every observed behavior can be explained or justified by self-interest maximization. Based on that assumption, ideas play no role in explaining individual behavior. While economics mainly focuses on explaining equilibriums and their stability, economists do apply this assumption to explain or predict institutional changes. In so doing, they model the institutional change as a game of players with different interests, such as the ruler vs. the ruled, the politician vs. the public, the employer vs. the employee, the landlord vs. the peasant, the capitalist vs. the worker, and so on. Under such modeling, the interests of every group are well-defined and every interest group makes choices to maximize its interests.

Consequently, institutional change is nothing more than moving from the old equilibrium to a new equilibrium. Ideas and leadership are completely ignored in this model.²

While the interest-based model of institutional change is simple and has some explanatory power regarding the stability of the institution, it hardly explains why institutions actually change. My observations suggest that many of the institutional changes that happened in human history were not because one (or new) interest surmounted another (the vested interests), but rather it was because the new ideas surmounted the old ideas—or because ideas trumped interests. For example, the success of the Chinese socialist revolution led by the Chinese Communist Party was not because the interests of the workers/peasants surmounted the interests of the capitalists/landlords, but because the Marxist-Leninist ideology won over other ideologies. Moreover, whereas revolutions and reforms are often against the groups with vested interests, the important driving force for these changes often comes from the elite groups with vested interests. For instance, the founding members of the CCP were almost exclusively from the then elite families, including landlords, rich middle-class members, warlords, and intellectuals. Why did these elites stand up for revolution? The answer is that they came to accept a new ideology—Marxism-Leninism. Similarly, the important driving force of the French Revolution in the late 18th century was the aristocracies of the old regime (see Greenfeld 1992: chap. 2). The Enlightenment was nobiliary, and many of the Enlightenment intellectuals came from the aristocracy. Interestingly, the revolution for overthrowing aristocracy was in fact partly the result of the aristocracies' effort. Likewise, the reason why George Washington and his fellow members instituted the America's constitutional republic, or why Deng Xiaoping launched China's market-oriented reform, cannot be explained by their self-interest maximization, but because they adopted new ideas.

Meanwhile, history has also demonstrated the crucial role leadership plays in institutional changes. Almost all institutional changes are initiated by a small group of people, sometimes even by a single political figure. These people are missionary, visionary, passionate,

²The exception is that when there are multi-equilibria, ideas may help to coordinate a particular equilibrium as a focal point.

risk-taking, and decisive. They have the ability and charisma to gather followers and to direct them. It is evident that without George Washington's leadership, the American political institution might have been very different; without Mao Zedong's leadership, China's revolution might have failed; and without Deng Xiaoping's leadership, China might have taken a very different road after Mao's death in 1976.

So why do ideas matter? It is because people are rational beings. As rational beings, we think, reason, and analyze before taking actions, and we act with a clear purpose. Every volitional action needs to be justified, and these justifications must be based on values and ideas. Human beings are different from other animals because we use values and ideas to guide our behaviors. As we all know, rationality is also the core assumption of economics. However, the rationality in conventional economics is often too narrowly defined as "instrumental rationality." In other words, rationality plays no role in choosing the ends. However, as Kant argued convincingly, the primary meaning of rationality is the selection of ends. Rationality should be the master, not slave, of passion. As people are social animals, we have various appetites, desires, and inclinations. As rational beings, however, we cannot just satisfy these appetites, desires, and inclinations regardless of the potential negative consequences. We must choose the ends (e.g., what desires to pursue) according to social norms and ethical principles. These norms and principles are constructed by ideologies. That is why philosophical and religious ideas are so powerful.

Rational people do pursue their interests. Nevertheless, the interests that govern their actions are the perceived interests. That is, people understand and perceive their interests through ideas. What is good and what is bad for them largely depend on what ideas and beliefs they hold (see Lukes 1974, 2005; Geuss 1981; and Hay 2011). As David Hume ([1742] 1987: Part I, Essay VII) pointed out more than 200 years ago, "though men be much governed by interest; yet even interest itself, and all human affairs, are entirely governed by opinion." For instance, about 60 years ago, when Chinese workers and peasants were told by the CCP that their interests conflict with those of capitalists and landlords, they stood up to join the socialist revolution by seizing the latter's properties. However, it proved afterward that their true interests were not fulfilled by, but in fact suffered from, this seizure of private property.

In other words, the concept of interests in conventional economics is flawed. Particularly, when economists assume that people maximize their utilities, these utilities are often understood as satisfaction of tangible or material interests. In fact, people's interests are much more than tangible and material interests. There are many non-material interests people care about. As social animals, people increase their happiness through relationships with others and are concerned with how others view them. One person's state of mind can affect another person's happiness or utility. We aspire to be respected by others, to have a good reputation, and to establish social esteem. For this reason, we must act justly and meet others' expectations. Our ideas of justice and fairness naturally affect our choice of actions. Therefore, intangible or nonmaterial interests are more likely to be influenced by ideas than are tangible or material interests. This is also a powerful reason why people are willing to initiate institutional changes even at the expense of their material interests. In this case, individuals make changes not to gain material benefits but to earn a good reputation, to get others' respect, and to leave a legacy.

Even if preferences are given, people's best choices depend on their understanding of how the world works and of what strategies are available to them, both of which depend on the ideas they accept and hold.³ No doubt, Mao Zedong and Deng Xiaoping each wanted to be a great man in history. Because they had different ideas of economic development, however, they chose different roads for China. Ronald Reagan and Margret Thatcher promoted economic liberalization in the United States and Britain because they accepted the idea that the world works better under the free market than government intervention—ideas developed by Friedrich Hayek and Milton Friedman. Those who believe in Keynesianism would certainly act differently.

Leadership is important in the process of institutional change because there is a great deal of uncertainty concerning the consequences of reform.⁴ In an uncertain world, institutional changes can be viewed as venture investments. It is almost impossible to calculate the costs and benefits of a particular change in terms of probability.

³See Dani Rodrik (2013) for more analysis of how ideas of the world and strategies affect the actions to be chosen.

⁴It should be pointed out that the basic reason why the role of ideas cannot be reduced to interests is because of uncertainty (see Blyth 2011).

Only a very small group of visionaries have the ability to see the opportunities for change, to grasp the opportunity, and to have the willpower and courage to alter existing institutions. These visionaries can be called “institutional entrepreneurs” or “political entrepreneurs” as they are the ones who either initiate ideas or first adopt new ideas and find ways to implement them through institutional changes such as developing reform policies. The success or failure of any institutional change, to a large extent, will depend on their decisiveness, persistence, and political skills. These visionaries differ from average people in that they care less about material interests than about respect, reputation, social esteem, and legacy. To serve the society and to do the right thing are the main motives for them to lead changes. Without their leadership, new ideas cannot be instituted, and no real changes can happen.

Given how important both ideas and leadership are in the process of institutional change, it is rather strange that they have been ignored by economists for so long.⁵ Denying the importance of ideas is equivalent to denying the value of economics itself. In my view, the purpose of economics (and other social sciences) is to develop new ideas or defend established ideas. If people’s actions are not affected by ideas, and if rational choices are totally independent of what economics says, as assumed by conventional economics, then economics would be totally useless, and doing economics is totally a waste of social resources. Similarly, ignoring leadership in the analysis of institutional change is like ignoring entrepreneurship in the analysis of the market. I therefore claim that conventional economics is fundamentally flawed in its basic assumptions. It is time for economists to rethink the current paradigm of equilibrium economics.

A Two-Dimensional Analytical Framework

The power of ideas and leadership is well demonstrated by the planned economic system that was once implemented in the countries that possess over one-third of the world population, including the former Soviet Union, Eastern European countries,

⁵There have been exceptions—such as Keynes, Mises, and Hayek—and more recently some economists have begun to incorporate the role of ideas and institutional entrepreneurship in their analysis of institutional change (see Leighton and Lopez 2013, Rodrik 2013, Coase and Wang 2013). Political scientists started this new research agenda earlier than economists (see Beland and Cox 2011).

People's Republic of China, and other developing economies. It is not convincing to say that those who once promoted this system did so for their own self-interests. It is more likely that they did so "for the interests of all the people." It was a winning of an idea. The idea came first from Marxism and was consolidated after the Great Depression in the 1930s. According to Marxist economics, the free-market economy is a chaotic and anarchic economy. The pursuit of profits by capitalists inevitably leads to successive economic crises and the waste of scarce resources. The solution to these problems is to have a central planning agent who has the authority to make an overall plan about what to produce and how to organize production, and then to implement the plan from the top-down. It was assumed that when resources are allocated according to the central plan for the "social good," economic crises and all other shortcomings of the capitalist market economy would be mitigated. For this purpose, all of the production materials must be controlled by the central government.

The idea of a planned economy seemed to make good sense when the capitalist countries experienced the Great Depression in the 1930s while the Soviet Union's economy performed strongly during the same period. Not surprisingly, the planned economic system was even endorsed by some mainstream neoclassical economists such as Oskar Lange. Mises and Hayek, the two leading Austrian School economists who strongly opposed the socialist planning economy, were assumed to have lost the battle.⁶ Thus, many developing and newly independent countries after the Second World War implemented Soviet-style central planning. It should be noted that the political leaders who led the implementation of the planning system in their countries were all strong leaders with great visions for their countries. Without their strong leadership, the implementation of the socialist economic system would not have been possible.

While the ideal sounds beautiful, the result of the planned economy has proved a disaster. Today we see that all of the socialist planned economies suffered from inefficiency of resource allocation, stagnation of technologies, and low living standards, compared with their capitalist counterparts. The Hungarian economist János Kornai (1980) coined "the shortage economy" to describe the

⁶For the history of the debate on socialist calculation, see De Soto (2010).

planned economy, meaning that everything was in short supply in the planned economy. Not only did all people lose their freedom and properties, millions of them lost their lives. For instance, in China, more than 30 million people died of starvation between 1960 and 1962 alone. It was the failure of the central economic planning that changed the ideas of the people in power, which in turn incentivized communist countries to make the transition to a market economy.

The story of the planned economies shows that ideas matter, whether they are right or wrong. John Maynard Keynes was absolutely right when he said, “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. . . . Soon or late, it is ideas, not vested interests, which are dangerous for good or evil” (Keynes 1936: 400).

Now let me present an analytical framework. As this article analyzes the transitional scenarios of institutional changes, I shall focus on the ideas of political leaders because it is these figures who initiate and lead changes. The ideas of ordinary people are often influenced or even instilled by political leaders. Having ideas is part of leadership. When we say someone is a good leader, we also imply that he has ideas we agree with. However, for ease of analysis, I will separate ideas from leadership and treat them as two distinct dimensions. I therefore propose a two-dimensional framework.

In the dimension of ideas, we can classify ideas into “right” and “wrong” categories. Here, of course, right and wrong make sense *ex ante* only in the eyes of the observers. For the holder of any particular idea, that idea is certainly right *ex ante*; otherwise he would not hold it.⁷ However, the same idea can be wrong for both its holders and observers *ex post*. People change their ideas only when they recognize that previously held ideas are wrong. Furthermore, the rightness or wrongness of ideas is not absolute; it is a matter of degree. So I treat them as two ends of a continuum.

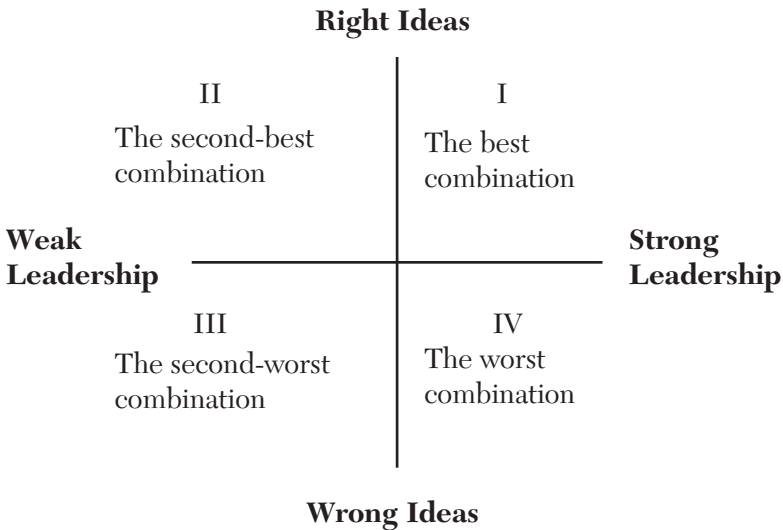
Leadership can be classified into “weak” and “strong” categories. By “strong leaders,” I mean politicians who are missionary, visionary,

⁷It should be noted that for strategic reasons one may claim he believes in some ideas when he does not. This idea falsification is particularly evident in non-liberal societies.

and passionate, as well as decisive, courageous, persistent, venture-some, and able to skillfully orchestrate resources and motivate supporters. Those who are short of the above characteristics are “weak leaders.” Strong and weak leadership are also treated as two ends of a continuum.

Figure 1 displays the two-dimensional framework regarding ideas and leadership. The best combination is right ideas with strong leadership in the first quadrant. The political leaders located in this quadrant are the best for institutional change because they have the capability to lead the society to establish better institutions. The worst combination is in the fourth quadrant. Political leaders located in this quadrant have strong leadership to implement their reform agenda, but their ideas are wrong. This combination will hurt society in the end. The second quadrant is the second best combination. The political leaders located in this quadrant have the right ideas but lack the leadership skills to implement them. The third quadrant is the second worst combination. The political leaders located in this quadrant have the wrong ideas, but fortunately do not have the leadership skills to fully implement them.

FIGURE 1
THE TWO-DIMENSIONAL FRAMEWORK



The institutional changes China has gone through since the Communist Party took power in 1949 can be well represented by the above framework. Mao Zedong ruled China from 1949 to 1976. His regime was located in the fourth quadrant. Mao was a very strong political leader; few people in Chinese history could be compared with him in leadership. He could accomplish almost everything he wanted to do, even the “Great Leap Forward,” which led to the death of millions of people. However, his ideas were completely wrong. He believed in the central planning system and political dictatorship. With his wrong ideas and strong leadership, he revolutionized the country politically, economically, socially, and culturally. As a result, the whole country suffered disastrously. By the time of his death in 1976, China was not only at the edge of economic bankruptcy, but also at the edge of political disorder.

Deng Xiaoping was located in the first quadrant. He ruled China de facto from 1978 until his death in 1997.⁸ He was also a strong political leader, but his ideas were very different from Mao’s. When Deng took power after the Cultural Revolution, he had little confidence in the central planning system, and came to believe in the market mechanism, grass root initiatives, entrepreneurship, and decentralization in economic development. He launched the market-oriented economic reform, and implemented most of his ideas before his death. His economic reform proved a success in terms of China’s economic growth and improvement of the living standard of ordinary people. Deng Xiaoping is often criticized for not initiating political reform. However, it is not clear whether he had wrong ideas about the political system or he had no time to implement what he had in mind but not yet articulated.

Deng’s successor Jiang Zemin (Party general secretary from 1989 to 2002) and Zhu Rongji (vice prime minister from 1992 to 1997, and prime minister from 1997 to 2003) are arguably located in the first quadrant. They both were strong leaders, though not as strong as Deng. They shared most of Deng’s economic ideas and continued his economic reforms. Under their leadership, China further liberalized its economic system, particularly the ownership structure. Privatization of state-owned enterprises and the expansion of

⁸Deng was no longer politically active after 1993. However, his leadership authority remained until his death in 1997.

foreign-invested firms mainly took place during the Jiang-Zhu era. By 2002 when Jiang and Zhu stepped down from the leadership role of the Communist Party, the nonstate sector contributed more than 60 percent to China's gross national product. China was also moving forward on the road to a rule-of-law country.

Jiang's successor Hu Jintao (Party general secretary from 2002 to 2012) and Zhu's successor Wen Jiabao (prime minister from 2003 to 2013) are arguably located in the third quadrant, although close to the origin of Figure 1. Hu and Wen were more conservative in their economic policies and political changes than their predecessors.⁹ They favored government intervention and the state sector over the free market and the private sector. As a result, economic reform during the Hu-Wen regime (2003 to 2012) was stagnant and even fell backward in some aspects. By 2012, the government became more powerful, and the state sector became stronger and more aggressive than in 2002. The transition to the rule-of-law society was also reversed.¹⁰

Figure 2 summarizes the above analysis and discussion about the four regimes.

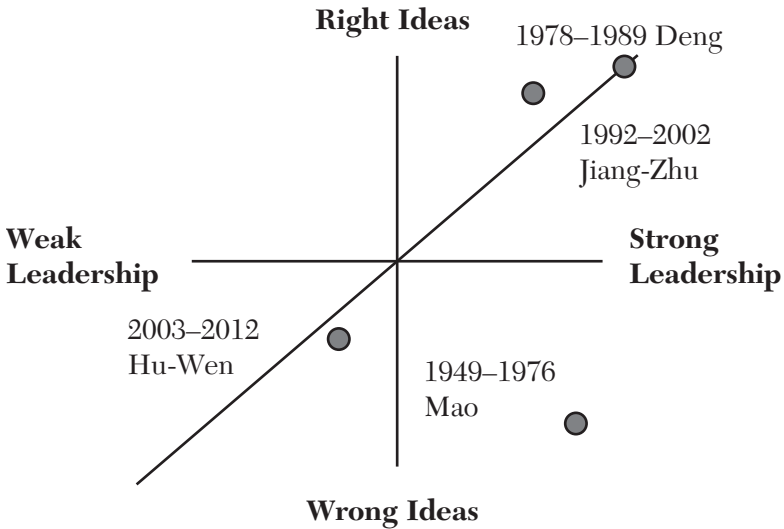
Ideas and Leadership during 1978–2002

In the first 25 years of the economic reform (from 1978 to 2002), China's leaders had the right ideas and strong leadership. Deng Xiaoping was no doubt a key person from 1978 to 1992. His reformist colleagues Hu Yaobang (general secretary of the CCP from 1980 to 1987), Zhao Ziyang (prime minister from 1980 to 1987, and general secretary from 1987 to 1989), and Wan Li (vice prime minister from 1980 to 1988, and chairman of the National People's Congress from 1988 to 1993) supported his reform program and shared many of his ideas. From 1992 to 2002, General Secretary Jiang Zemin and Prime Minister Zhu Rongji followed Deng's reform agenda. Their ideas and leadership trumped the conservatives and the vested interests, and led to the success of the economic reform of that period.

⁹Wen seems less conservative than Hu in political reform. He quite often argued for political reform. However, many people think he was doing a publicity stunt.

¹⁰Lardy (2014) disagrees with the judgment of the resurgence of the state sector during the Hu-Wen era. His arguments are misleading because he does not pay enough attention to changes in the political attitude toward private firms, enhanced restrictions on market access, discriminatory industrial policies, and local government conduct during the Hu-Wen Era.

FIGURE 2
IDEAS AND LEADERSHIP IN CHINA, 1949–2012



Due to space limitations, I cannot present a full story of this period. Instead, I shall give a few examples to show how the reforms of this period relied on right ideas and strong leadership.

The Rural Reform

China implemented the people’s commune system in rural areas in 1958. Under this system, all land and production materials were collectively owned and all agricultural productions were conducted collectively. Because peasants did not own any land and output, they had little incentive to work. As a result, China suffered from food shortages for a long time under the commune system. The agricultural reform was a matter of survival for the Chinese people after the Cultural Revolution. However, when the reform started, the newly proposed “household responsibility system” (*baochan dao hu*), which would allow agricultural production decisions to be contracted down to individual households, faced strong resistance even in some poor rural areas. The resistance mainly came from the vested interests of the then cadres of the commune and production brigades, and some top leaders with the old Marxist ideology. For example, Chen

Yonggui, the then vice premier in charge of agriculture, strongly opposed the reform. Chen was supported by the then Party chairman Hua Guofeng. Chen reached this top position through successive promotions only because his brigade (Dazhai Village) was established as a role model of the collective production. The reform was no doubt a denial of his political legitimacy.

Despite these fierce oppositions, the agricultural reform took place and spread quickly nationwide. The success of this reform could be attributed to the ideas and leadership of Zhao Ziyang and Wan Li, supported by Deng Xiaoping.¹¹ Wan was then the Party secretary of Anhui Province. He recognized that the commune system was not working, and that the only way for peasants to have motivation to work hard was to privatize agricultural production. When some villagers in Anhui Province adopted the household responsibility system, he gave his full support. Conservatives at the central government organized various conferences and used official media to attack the household responsibility system, even accusing Wan of “going on the capitalist road” and “undermining socialism.” When Chen Yonggui criticized him in November 1978, he told him bluntly: “You say you are speaking from the Dazhai experience; I say Dazhai is an ultra-leftist model. . . . You go your way and I’ll go mine. . . . Don’t impose your views on me and I won’t impose mine on you. As for who is right and who is wrong, let’s see which way works best” (Vogel 2011: 438). The debate on agricultural reform diminished only when the reform proved a success in solving the food shortage problem. In 1983, the National People’s Congress passed the new constitution that officially dismantled the commune system. By 1984, China’s grain became oversupplied.

Openness and Reform in Guangdong Province

The openness policy was an important part of Deng Xiaoping’s reform program. It started in Guangdong and Fujian Provinces. During the age of the planned economy, these two provinces were designated as the “first front line” for possible war against the

¹¹When Zhao was Party Secretary of Sichuan Province, the household responsibility system occurred with Zhao’s permission. Sichuan Province’s initial rural change did not draw public attention, however, since Zhao kept it secret. For an excellent description of the rural reform story, see Vogel (2011; chap. 15).

Nationalist Party–Controlled Taiwan. The government had little investment in them. By the end of the Cultural Revolution, these two provinces were among the most underdeveloped. However, they had great potential in economic development because of their geographical links to Hong Kong and also as homelands of hundreds and thousands of overseas Chinese who have a great deal of business experience. For this reason, Deng Xiaoping chose the two provinces as pilot areas for the openness policy.

At the beginning, the openness policy and reform in Guangdong and Fujian also met a lot of resistance from both the vested interests and old ideology. The vested interests were mainly from the central administrative agencies whose power was seriously challenged by trade liberalization and decentralization. Without the right ideas and strong leadership, it would have been impossible for the openness policy to succeed. Just as Wan Li's ideas and leadership played an important role in the agricultural reform, it was Ren Zhongyi's ideas and leadership that made the difference in Guangdong. Ren was appointed as the Party secretary of Guangdong in November 1980. He completely identified with Deng's ideas. However, with the increasing trade liberalization and overseas investment (mainly from Hong Kong), two new phenomena occurred, which presented a big political challenge for Deng's openness policy. One was corruption, and the other was smuggling. It was easy for the rich Hong Kong businesspeople to bribe poor Guangdong officials. Given the big price gap between Hong Kong and Guangdong, it was very profitable for people to smuggle. These two phenomena were often used as reasons by the conservatives to oppose the openness policy. The local conservatives repeatedly reported to the central conservatives that corruption and smuggling spread unchecked in Guangdong. Ren Zhongyi was under tremendous pressure and was frequently recalled to Beijing by the Central Disciplinary Committee of the CCP led by conservative Chen Yun (a major political rival of Deng Xiaoping) to do self criticism. In one case in 1982, Ren was charged of supporting capitalism and breaking socialism in Guangdong. With such high political pressure, Ren had to acknowledge his responsibility against his will. But he worried about how to tell his Guangdong colleagues and subordinates when he returned to his office. Ren was a loyal Party member. According to the CCP's discipline, he must tell the true story. However, he knew that once the true story was revealed, his colleagues and subordinates would think that the openness policy

was reversed and would lose their confidence. He decided to go to see Hu Yaobang (the Party secretary) for advice before returning to Guangdong. Hu smiled and said to him: “You can tell them whatever you like.” With Hu’s tacit support, Ren didn’t tell the true story of the criticism of him and continued to push for openness. For Ren, while corruption and smuggling should be checked and restrained, openness and reform should not be given up. Meanwhile, Deng Xiaoping took every opportunity to give his support to what Ren did in Guangdong. With Ren’s leadership and support from Deng Xiaoping, Hu Yaobang, and Zhao Ziyang, Guangdong pioneered many reforms, including price liberalization. By 1985 when Ren was retiring at the age of 70, Guangdong had been recognized as a role model of openness and reform for other provinces (see Vogel 2011: chap. 14).¹²

Development of the Private Sector

China did not have any private firms under the centrally planned economy. Private businesses started in rural areas when agricultural production was liberalized. In the urban areas, private businesses were permitted initially only for pragmatic reasons. When more than 20 million “educated youths” who were sent to the countryside during the Cultural Revolution returned, the state sector was unable to accommodate them. To avoid social unrest, the government allowed jobless returnees to be self-employed. Interestingly, business has its own logic. When the self-employed people did well in their businesses, they started expanding them by hiring other people. This outcome presented a conflict with the Marxist ideology. According to orthodox Marxism, hiring other people to work for your business is exploitation and is inconsistent with socialism. To solve this dilemma, a few Chinese Marxist economists appealed to Marx’s *Das Kapital*. Based on the detailed analyses of Marx’s arguments, they concluded that employing fewer than eight employees was not exploitation. This provided an official legitimacy for small businesses. Nevertheless, more and more successful private businesses broke the ceiling of eight employees and some even hired hundreds of employees.

¹²Xia Nan, the Party secretary of Fujian Province, was also a strong reformer. He was dismissed in 1986 under pressure of conservatives after a faked medicine case in Fujian.

Policemen asked if these big employers were criminals and should be arrested.

Deng Xiaoping was very smart in solving this problem. The well-known story is as follows. Nian Guangjiu, a private businessman in Wuhu City, Anhui Province, started his melon seed roasting business as a self-employed person. His products were well received by consumers, so his business expanded cross-regionally. He made considerable profits. In the end, the number of his employees reached several hundred. Local government officials thought that he should be arrested for the crime of exploitation. However, they didn't dare to make a decision. They reported the case to higher-level government officials. Nevertheless, even higher-level officials didn't dare to make a decision. The case eventually arrived at Deng's desk for a final decision. Deng reviewed the case and said: "Don't arrest him. One person like Nian cannot shake socialism." That was Deng Xiaoping! He didn't say that employing hundreds was not exploitation. He just said that socialism should not be afraid of the development of private businesses, no matter how big they grew. By so saying, he sent an important message to the Chinese people that private businesses were welcomed in China.

Because of the legal and ideological constraints, the development of the private sector was not going smoothly in the early stages of reform. During that time, we often heard that some private businesspeople were arrested and sentenced as economic criminals when conservatives were in a dominant position in political and ideological struggles. Deng Xiaoping had to make a concession in unfavorable situations. However, with his right ideas and strong leadership, he eventually won the battle. In October 1987, the 13th Congress of the CCP officially recognized private enterprises as a "supplement" to the "socialist economy." In April 1988, the Constitution amended by the 7th National People's Congress eventually gave private enterprises legal status.¹³

Toward a Socialist Market Economy

Deng's economic reform experienced a setback after the Tiananmen Massacre in 1989. This incident provided an unusual opportunity for the conservatives to fight back. They blamed the

¹³For rich stories of debate on private businesses, see Yang (1998).

market-oriented economic reform and liberalization for being the cause of the incident. Many of Deng's reform ideas were criticized in the official media. Many previously implemented reform measures were reversed. Private enterprises and even township and village enterprises (TVEs) faced a crackdown. Some liberalized prices were re-regulated. Deng tried to stop this anti-reform current but was not successful for a while. His reform-centered speeches in Shanghai in the spring of 1990 and 1991 could not even be published in conservative controlled central media.

This conservative aggression worried Deng a great deal. He realized that if the trend continued, his economic reform would end halfway and Chinese socialism would have no future. Thus, three years after the Tiananmen incident, Deng launched his final fight to rescue his reform program. In January and February 1992, the 88-year-old Deng Xiaoping made his famous tour of Southern China with his family. The tour was claimed to be a vacation, but actually it was a well-planned political tour. During his first stop in Wuhan, the capital of Hubei Province, he told the accompanying local senior officials: speed up reform; whoever is not committed to reform should step down. In Shenzhen and Zhuhai, the two special economic zones in Guangdong, Deng visited a few modern manufacturing companies and reaffirmed the achievements of the special economic zones. He told the accompanying local officials that planning is not equal to socialism, and the market is not equal to capitalism; capitalism has plans, and socialism has markets; and poverty is not socialism. He criticized conservatives who were trying to reverse his reform policies.

As Deng's speeches on his Southern Tour spread unofficially through Hong Kong based media, the atmosphere began to change. With Deng's political influence among local officials and military officers, the conservatives turned from offense to defense. The Party general secretary Jiang Zemin sensed that Deng won the battle against conservatives and quickly expressed his support for Deng's call for reform. Other senior leaders followed suit. Official newspapers also began to publish editorials to call for reform. In March 1992, the politburo endorsed Deng's speeches and the revised speeches were circulated as an official document to all Party members and taken as a guideline for future reform.

Deng Xiaoping's Southern Tour was a turning point in China's reform process. The 14th Congress of the CCP, which was held in

October 1992, re-endorsed Deng's reform policy, and set "building a socialist market economy" as an official reform goal, which was a breakthrough of the original economic reform goal. More reform-minded people were selected into leadership positions. In November 1993, the Third Plenary Session of the 14th Congress made "the decision of building a socialist market economic system" and laid out a detailed reform agenda. Under Jiang Zemin's leadership, China's reform began a new chapter.¹⁴

Privatization of the State-Owned Enterprises

The reform of state-owned enterprises (SOEs) had been the core part of the whole economic reform program in China up to 2003. The major idea shift of this reform occurred in 1993. Before 1992, the SOE reform was discussed under the premise of maintaining state ownership. Assuming that SOEs could be managed well, the question was how to manage them well. This way of thinking had both ideological and cognitive reasons. The ideological reason was that the state ownership was the foundation of the socialist economy. The cognitive reason was that SOEs could be made as efficient as private enterprises by imitating the management and incentive systems of private enterprises in the West. Thus, two major measures were implemented in the early days to improve the SOEs' performance. The first was to expand management autonomy; and the second was to implement profit sharing and bonus systems. By 1986, these two policies had evolved into the "management responsibility system" under which the government and enterprises entered into contracts, and when the contracts were completed the profits were shared according to the terms specified in the contracts. There are many ways to share profits, but the premise of all measures was to maintain state ownership.

However, by 1992, it was clear that there was no way to resolve the problems with the SOEs under the constraints of state ownership. After more than 10 years of trying to separate administration from enterprises, as well as trying to implement profit and loss responsibility, those goals could not be realized under the existing institutions. In particular, with the development of the nonstate sector (including

¹⁴For details of Deng's Southern Tour and the subsequent reform agenda, see Vogel (2011: chap. 23).

TVEs and joint venture companies) and the intensification of inter-regional competition, the survival of SOEs was in question. SOEs had long been the pillar of the national economy and the main source of government revenue. However, they now became a burden to local governments. In 1992, the total loss of the industrial SOEs exceeded their total profits. Therefore, the fundamental thinking regarding SOEs began to change, and new thinking about privatizing them took root.

At the Third Plenary Session of the 14th National Congress in 1993, four principles of a systemic reform were established: “clearly established ownership, well-defined power and responsibility, separation of enterprise and administration, and scientific management.” Many localities began the process of denationalization. The official mottos were “building a modern enterprise system,” “transformation of the joint-stock system,” “corporatization,” and “property rights diversification.” Large-scale systemic reforms of ownership started for enterprises controlled by local governments, especially those controlled by county and lower level governments (including rural enterprises and other forms of collective enterprises). In 1995, General Secretary Jiang Zemin proposed to “invigorate large enterprises and loosen control over the small.” A very famous story of that time is from Zhucheng City, Shandong Province, where 50 SOEs under the control of the city’s government were sold. The Party secretary of the municipal committee, Chen Guang, got the nickname “Chen Maiguang” (“Completely Sold Out”).

By the middle of 1990s, the central government-controlled enterprises had also become burdens to the central government. The huge nonperforming loans of SOEs were threatening the banking system. After the 1997 Asian financial crisis, state-owned banks stopped providing SOEs with “stability and unity loans.” Central enterprises had no option but to start the denationalization reform. The mottos at the time were “structural reorganization,” “decrease staff and increase efficiency,” and “overcome difficulties.” Under these guidelines, a large number of enterprises, especially small- and medium-sized enterprises, were cast off. At the same time, the government initiated the formation of joint-stock ownership for large-scale SOEs. Turning SOEs into joint-stock companies, and then reorganizing them with high-quality assets to go public, was an extraordinary measure. As the continuation of Jiang Zemin and Zhu Rongji’s reform, in 2003, “technically

insolvent” large-scale state-owned banks also started to transform into joint-stock companies. They brought in foreign strategic investors, and then went public on domestic stock exchanges.¹⁵

While the SOE crisis was a driving force for changes in people’s thinking in the 1990s, I believe the ideas and leadership of Jiang Zemin and Zhu Rongji played a crucial role in transforming management reform into ownership reform. For ideological reasons, interestingly, the then Chinese leaders and the official documents avoided the word “privatization,” even though what China did with SOEs under the Jiang-Zhu regime was nothing but a kind of privatization. They did so because they believed that changing ownership was important and necessary for solving the SOE problem and building a market economy. With the constraints of old ideology and the political and social pressures, strong leadership was absolutely needed to implement Jiang and Zhu’s ideas. In 1998 alone, about 20 million state employees were laid off when the state sector was restructured. Without Jiang and Zhu’s decisiveness and courage that task would have been impossible.

China’s Entry into the World Trade Organization

One of the most important reforms China made during the Jiang-Zhu regime was to enter the World Trade Organization in 2001. Joining the WTO played a crucial role in fostering China’s double-digit growth as exports became a major driving force for industrialization and urbanization. Huge foreign investments flowed into China. Most of the Fortune 500 multinational companies started their manufacturing businesses in China. China quickly became a hub of world manufacturing. With favorable global markets, China’s exports grew even faster than imports. As a result, China accumulated a huge amount of foreign reserves, now accounting for one third of the world reserves.

Entry into the WTO also played an important role in driving China’s domestic economic reforms. To meet the requirements of the WTO, China launched the deregulation campaign a few years before 2001, which removed many administrative controls over economic activities. China also abolished many regulations affecting

¹⁵For privatization of state sectors, see Li, Li, and Zhang (2000), and Zhang (2015: chap. 11).

trade and investment, and reduced tariff rates dramatically after the entry into WTO. As a result, the Chinese market is more open and China is more like a global player. The competitiveness of Chinese companies has also improved considerably. Without entry into the WTO, both the institutions and the business culture of China would have been very different.

While the benefits of China's entry into the WTO became clear afterward, there were interest groups who opposed membership. The debate on the pros and cons of joining the WTO was heated before 2001. Opposition came from those who had wrong ideas or vested interests. Some thought that entry into the WTO was against China's national interests and would undermine manufacturing. Because of the weak competitiveness of Chinese firms, it was feared that WTO membership would cause many Chinese firms to collapse and destroy jobs. Vested interests mainly were two types: (1) SOEs that were long protected by high tariffs and quotas and enjoyed monopoly positions in domestic markets, and (2) government officials who had administrative power to set and implement rules, and therefore had rent-seeking opportunities.

These vested interests not only voiced their opinions but also took actions to block necessary concessions China should make. They even accused Premier Zhu Rongji and the head of WTO negotiation delegation Long Yongtu of being "traitors." However, Jiang and Zhu were determined to get China to join the WTO. They strongly believed that the entry into the WTO would provide plenty of opportunities to China, and being an equal member of the WTO family would be important for China to rise internationally. They were willing to make all necessary concessions to meet the WTO rules, even in the face of strong opposition. With such determination, China was able to reach all bilateral agreements and eventually entered the WTO in November 2001. It is evident that without Jiang and Zhu's decisiveness, China would not have entered the WTO as early as in 2001.

In summary, the above six stories show that the right ideas and strong leadership of Deng Xiaoping, Hu Yaobang, Zhao Ziyang, Wan Li, Jiang Zemin, and Zhu Rongji, among others, in the first 25 years since the inception of reform were crucially important for China's economic reform and openness. Without their right ideas and strong leadership, China would not have achieved such success in its transition to a market economy.

Ideas and Leadership, 2003–2012

As Hu Jintao succeeded Jiang Zemin as the Party general secretary in November 2002 and Wen Jiabao succeeded Zhu Rongji as the prime minister in March 2003, China entered the Hu-Wen decade until late 2012. While the economic growth was strong due to the accumulated dividends from the first 25 years of reform, the Hu-Wen decade can be called a “lost decade” in terms of economic reform. Not only did China not move forward in its institutional changes, but actually its reform momentum was reversed. Many conservative policies against market-orientation were implemented. The government became more interventionist, the state sector became more dominant, and the rule of law was seriously damaged. By the end of the Hu-Wen decade, the Chinese society had become much less harmonious than a decade ago. It seemed that many people were dissatisfied, regardless of whether they were rich or poor, officials or common folks, or an employer or employee.

One explanation for this setback was that Hu Jintao and Wen Jiabao had wrong ideas about reform; they were also weak leaders. They believed in the government more than the market, state ownership more than private ownership, and the rule of the Party more than the rule of law. Hu and Wen behaved more like bureaucrats than visionary leaders, and it seemed that reform was losing its legitimacy. Moreover, even though “continuing reform” was still their open and official slogan, what they did was in fact very different from what they said. As such, with the passage of time, few people really cared about what they were saying. Because of their weak leadership, much of the reform operations were left in the hands of the bureaucracy of vested interests. These bureaucrats made the best use of their discretionary power to manipulate reform programs and consolidate their own status and personal interests, rather than push the economic system in the direction of the market. As a result, corruption and rent-seeking at all government levels became prevalent, and more and more businesspeople lost confidence in the Hu-Wen regime and chose to move abroad. Below I identify four major setbacks.

From Market Orientation to Government Intervention

As I mentioned earlier, China had taken a long time to build its trust in the market. It was only in 1992 that “building a socialist

market economy” was taken as an overall goal of the reform by the 14th National Congress of the CCP. Nevertheless, after a decade of efforts to build a market economy under the Jiang-Zhu regime, the direction began to change under the Hu-Wen regime. During this time, the market was regarded as a problem and government as a solution, just the opposite of the 1990s. Faith in governmental intervention was further strengthened after the global financial crisis in 2008–09. With the reversal of ideas, many planning-type measures were kept or reintroduced under the Hu-Wen regime, of course in the name of “perfecting the market” and “curing market failures.” So-called industrial policy became an umbrella for the various government interventions, including restraints on market access, resource distribution, taxation and subsidies, and compulsory reorganization of enterprises. During the planned economy, the State Planning Commission was the most powerful government agency. In some sense, the essence of the economic reform was to diminish the power of the Planning Commission. China indeed did that during the first 25 years of reform. However, under the Hu-Wen regime, this commission, renamed in 2003 as the National Development and Reform Commission (NDRC), fought back very aggressively and reestablished its dominant position on investment decisions and resource allocation. Now the NDRC is more like a second State Council. Almost every investment project needs to be examined and approved by the NDRC (or its local equivalent) through various administrative procedures. Without its approval, enterprises cannot do anything new. The NDRC also controlled tremendous government investment funds of the various industries. Its officials have the discretion to allocate funds to whoever they deem worthy. Because they are so powerful, even the governors of provinces must kowtow to the NDRC division heads. Without a good relationship with NDRC officials, it is almost impossible for local governments to go forward with their development projects.

Ironically, while the industrial policies attempted to solve the overcapacity problems and investment wastes “resulting from the market competition,” they actually made the situation worse. In 2009, the government launched a “plan of re-energizing the 10 big industries” in the face of the challenges from the global financial crisis. Two or three years later, however, all these 10 industries were found to be in trouble because of the production overcapacity. The solar energy industry was a typical example. This is a new industry,

and the Chinese private businesses did it well initially. However, it suffered a disaster because of the industrial policy. When the government designated this industry as a “strategic industry for future development,” a tremendous amount of financial resources were injected in it and many local governments competed fiercely to attract investors through cheap land, financial subsidies, tax holidays, and other favorable treatments. As a result, the solar energy industry spread quickly and developed overcapacity. With prices in a freefall, all of the producers suffered losses and some leading companies (e.g., Suntech Corporation) declared bankruptcy.

From State-Out and Private-In to Private-Out and State-In

During the Jiang-Zhu regime, state-owned enterprises were often criticized for their inefficiency and unprofitability. Through the various forms of restructuring and ownership reform, SOEs retreated from most of the competitive sectors and private enterprises took over. This process was referred to as “state-out and private-in” or “state-sector retreat and private-sector forward” (*guotui minjin*). However, during the Hu-Wen regime, SOEs were appreciated for their contributions to the national economy and to the ruling of the Communist Party. State-out and private-in was replaced by “state-in and private-out” or “state-sector forward and private sector retreat” (*guojin mintui*). The state-owned enterprises became more aggressive in every major industry and reentered a few already retreating competitive sectors. Through administrative measures, the SOEs took over private enterprises. This was particularly evident in the energy and steel industries, and private enterprises were more discriminated against in market access, financing, and taxation. Many owners of the privatized enterprises were arrested and sentenced in the name of “stealing state assets.”¹⁶

The original purpose of establishing the State Asset Supervision and Administrative Commission (SASAC) was to reform the state-owned enterprises. Nevertheless, soon after SASAC was established in 2003, it claimed that its function was to make SOEs bigger and stronger. This was done by monopolizing market access, reorganizing through mergers and acquisitions, and bully private enterprises.

¹⁶This charge was frequently used for the government to confiscate enterprises that were sold to private owners during the 1990s.

Li Rongrong, head of the SASAC from 2003 to 2010, once said that “the state-owned enterprise is the oldest son of the People’s Republic,” meaning that SOEs are entitled to privileges—for example, by excluding private enterprises. After the global financial crisis, a large amount of stimulus funds and loans were injected into SOEs, which made them more dominant. These policies of the central government also changed the mindset of local government officials. For instance, Zhejiang Province had long promoted the private sector, and Guangdong Province had long promoted foreign invested enterprises. However, in the late first decade of the 21st century, both provinces implemented various preferential policies to attract large SOEs controlled by the central government to invest in their provinces.

From Wealth Creation to Income Distribution

During the first 25 years of reform, Chinese leaders made economic development a top priority and viewed economic reform as the only way to advance economically. Deng Xiaoping realized that China’s poverty problem could be solved only by making the entire pie bigger. He persistently emphasized that “economic development trumps everything” and Jiang Zemin followed him. However, Hu Jintao had different ideas. For him, pie distribution was more important than pie-making. He downplayed the priority of development and emphasized “social harmony,” the true meaning of which in his mind was that income should be redistributed more equally through government’s administrative measures. He promised the ordinary people to increase their income by governmental intervention (such as minimum wages, collective bargaining, and income taxation), and introduced various welfare systems. Under his regime, entrepreneurs were defamed for greed and exploitation.

While income distribution in China needs to be addressed seriously, I argue that to deal with this issue, we first need to understand where an unfair income gap comes from. My observation suggests that the true issue related to China’s income distribution is unfairness, not inequality. The main explanation for unfair distribution is related to the fact that some people were given privileges in doing business. Furthermore, the reason that some people were given privileges but others were not was due to the overregulation and tight government control over many resources. Under such a system, the few got rich not because of their productivity and entrepreneurship,

but because of their special connections with the government. That is why ordinary people are dissatisfied with the income gap. What China needs to do is to level the playing field and create equal opportunity, not equal outcomes.

The right way to deal with the issue of income distribution is to further the marketization of the economy through deregulation, privatization, and implementation of the rule of law. However, the Hu-Wen regime thought very differently. They were confused about the differences between inequality and unfairness, but accepted the idea that the observed inequality was a natural result of the market. Therefore, they thought that the only way to solve the problem is through government's redistribution policy. Unfortunately, the result proves the opposite. After the decade of "building a harmonious society" under the Hu-Wen regime, the Chinese society had become much less harmonious than a decade ago. The corruption-related unfair income gap is also more serious than ever before. Once again, when ideas are wrong and leadership is weak, the outcome is often not as intended.

From Rule of Law to Rule of the Party

In Mao's era, China was lawless and Mao himself was the only law for the country to follow. Mao's rule of man resulted in a series of social and political movements and eventually led to the disastrous Cultural Revolution. Deng Xiaoping learned from Mao's mistakes and realized that ruling by law would be crucial for China's stability and development. Thus, once he took power, he proposed to institute legal and democratic reforms in China. During the Jiang-Zhu regime, the Communist Party officially set "building a rule-of-law state" as the goal of China's political reform and made tremendous efforts to achieve that goal. Under the leadership of Deng and Jiang, China made considerable progress on the road to the rule of law. However, the rule-of-law process was reversed during the Hu-Wen regime. For Hu Jintao, the top principle was "maintaining stability" rather than the rule of law. The rule of law became an empty slogan rather than a real ideal for society. Instead, the law was put aside and political measures dominated the resolution of social conflicts. The CCP's political and legal committees became much more powerful than ever before and interfered at will with judicial decisions. As a result, many legal cases evolved

into political events that could only be solved through political processes, and basic human rights and private property could not be respected and protected.¹⁷

Bo Xilai's Chongqing presented a typical example of the setback in the rule of law. When Bo was the Party secretary of Chongqing Municipality from October 2007 to March 2012, he launched a campaign called the "Sing Red and Strike Black" (namely, sing revolutionary songs and crack down on organized criminals).¹⁸ During this campaign, the court, the prosecutor, and the police were all put under Bo's control and made decisions jointly, little different from the Cultural Revolution. Anyone could be arrested at Bo's discretion. Indeed, many innocent businesspeople and even police were arrested and even sentenced to death, and their properties were confiscated. A few lawyers who defended their clients were arrested and sentenced. It was evident that if there had been adherence to the rule of law, Bo would not have been able to behave the way he did.

It should be noted that the setback of the reform during the Hu-Wen regime was influenced by two schools of wrong ideas. The first can be called the "Reform Failure School," which emerged in 2004 and 2005. This school attributed income inequality, shortage of medical care, underprovision of education, pollution, and regional inequality to neoliberal economic reforms and marketization. The solution proposed by this school was to strengthen government invention and reverse marketization. Under the influence of this school, from 2004 on, the SOE reform halted, and other related economic reforms were also interrupted. Marketization lost its legitimacy, and the government exercised greater control over the economy. During the global financial crisis in 2008 and 2009, when the Chinese economy was still growing, Beijing became overconfident. Consequently, the "China Model School" emerged. The core tenants of that model were single-Party rule, powerful government control, and dominance of SOEs. The China Model School claimed that the success of the Chinese economy was due to the fact that

¹⁷For the reversal of the rule of law during the Hu-Wen regime, see Jiang (2010). Jiang Ping is a leading legal scholar in China and was heavily involved in law-making during the 1980s and 1990s.

¹⁸Bo was dismissed on March 15, 2012, and sentenced to life for corruption and misfeasance on September 23, 2013.

leaders did not follow the “Washington Consensus”—that is, they did not accept the ideas of liberalization and privatization.

Although, on the surface, the first school says the reforms failed and the second that they succeeded, the essence of the two schools is the same—namely, the denial of market-oriented reform. The Reform Failure School negated the marketization that took place during the first 25 years under the leadership of Deng and Jiang, while the China Model School rejected any further marketization and privatization. The Reform Failure School provided the legitimacy for the anti-marketization policies after 2004, while the China Model School provided the legitimacy for the large-scale stimulus policy and the government dominance of investments after 2009. However, both of these schools are wrong in their analyses and conclusions.¹⁹

The Challenges for Ideas and Leadership in the Next Decade

China has made considerable progress in the past three and half decades in its transition to a market economy, even with the stagnation during the Hu-Wen regime. However, it still has a long way to go to become a democratic/liberal society. The key to transitioning China into a liberal society is whether China can succeed in its political reform. The last three and half decades have been dominated by economic reform. Now a fundamental political reform is urgently needed. Establishing a rule of law and a democratic system should be the major targets of political reform. It may take another three decades, but the next decade under General Secretary Xi Jinping’s regime will be crucial to start political reform. Whether or not China can succeed in its political reform also depends on ideas and leadership. In my judgment, China is now bound by some wrong ideas and the bureaucratization of leadership.

Six Traps of Wrong Ideas

I identify six traps of wrong ideas. If China cannot get out of these six idea traps, political reform will be impossible.

¹⁹For a detailed analysis of the two schools, see Zhang (2012a).

Trap One: China's Economic Success Comes from the China Model. The argument embedded in the China Model School is that China has succeeded in the past three decades because it has created its own unique governance system, and it is this unique system that drove China's achieving in just three decades what it took the West 200 years to achieve. Therefore, China should continue its own model rather than follow the West's model. As I mentioned earlier, the idea of the China Model School is wrong. The fast economic development in the past three and half decades was because China enjoyed a "late-comer advantage," which is common to all other late-comers. Using the terminology of Hayek, the Chinese economy is a parasitic economy (Hayek 1960: 47). The West constructed the road; China just followed it. That China walked faster does not mean that its institutions are superior. As Hayek argued convincingly, the sciences, technologies, and managerial skills developed in free societies can be borrowed by unfree societies to support economic development. As such, the latter can even have faster growth rates for a limited period of time.

Just looking at most of the technologies Chinese companies use and the new products they massively produce, including computer, mobile phone, car, airplane, Internet, and so on, most of them are innovations of the Western free societies; they are not China's innovation. As the late-comer's advantages are diminishing over time, China's future development will crucially depend on its homemade innovation. Without the fundamental changes in its political institution, the late-comer's advantages would eventually turn out to be a curse.²⁰

Trap Two: Economic Liberalization Can Continue without Political Reform. The second prevalent wrong idea is that China's economic success in the past three decades shows that even without political democratization, economic liberalization and high growth are possible. This idea is wrong for two major reasons.

First, while economic liberalization alone can provide considerable incentives for business activities and therefore economic growth in the early stage when the growth is mainly driven by the reallocation of the existing resources directed by arbitraging, as people have wealth to protect and innovation becomes crucial for growth, the rule

²⁰This point was first raised by Xiaokai Yang in his lecture notes.

of law becomes a necessity. Without the rule of law, property rights are always at risk of confiscation, and entrepreneurs would not have enough incentive to innovate because innovation takes much longer than arbitraging activities. The massive immigration of Chinese entrepreneurs into foreign countries in the past decade signals the serious need of property rights protection, which can be met only under a system based on the rule of law.

Second, the Chinese government needs new legitimacy for ruling the country. The rule of the CCP was originally from its winning the blood revolution. For a long time, the Chinese people have accepted this traditional legitimacy. However, this is no longer sufficient. According to Chinese tradition, the legitimacy of the ruling regime also depends on the living conditions of ordinary people under the regime. Deng Xiaoping realized that the Communist Party could sustain its rule only when it let people achieve good living standards. So, he launched the reform. In some sense he succeeded, as the Chinese Communist Party is still in power long after the Soviet Union and the communist regimes in Eastern Europe collapsed. Nevertheless, as the survival problem has been solved in China, the Chinese people are and will no longer be satisfied with a comfortable material life. They need dignity, freedom, and self-expression.²¹ If the government cannot protect people's basic human rights, including the freedom of speech, press, and religion, its legitimacy will be seriously challenged. Even within the Communist Party, without some form of democracy, the legitimacy of its leaders would be questioned. This calls for political reform to build the rule of law and democracy. Only through such political reform, can the Chinese government gain its new and urgently needed legitimacy.

Trap Three: The Status Quo Is Good for the Vested Interests. A dominant idea among the ordinary people as well as among the elite is that the status quo benefits the vested interests groups at the expense of others. This idea seems to be reasonable on the surface. There are conflicts between the vested interests and others. But a deep analysis shows that this idea is not right. The existing system actually turns out to be good for nobody, even the vested interests. While the vested interests enjoy privileges, they lack the basic human

²¹Based on data of the World Value Survey, Inglehart and Welzel (2005) provide a very convincing argument for democratization as the survival value is overtaken by the self-expression value.

rights such as free speech and personal security, just like other ordinary people. Even though privileges give them better opportunities to be wealthy and powerful for the time being, the lack of human rights implies that they are always at political risk—neither their personal freedom nor their property is secure. Under the current system, anyone can be arrested without going through a legal procedure, regardless of seniority.²² The interesting thing is that the conflicts of interests among the ruling elites are actually much greater than those between the rulers and the ruled. Anyone can become the victim of the political power struggle. As a result, the vested interests are living in anxious situations. Not only those who are judicially sentenced for corruption or for political reasons have lost their freedom, even those senior officials who did not commit any financial fraud feel like they are living under house arrest. For instance, a retired minister could not even go abroad to visit his children and relatives. So why would the vested interests think the current system is good for them but institutional reform would hurt them? The answer is that they are too ignorant. Once the vested interests realize where their true interests reside, they would more likely support, or at least less likely resist, political reform, even if they still want to retain their power. In the long run, the rule-of-law system is better than the rule-of-man system even for the elite, as demonstrated by British history (North, Wallis, and Weingast 2009).

Trap Four: State-Owned Enterprises Are the Cornerstone of the CCP's Ruling Power. One of the ideological barriers to privatization of the state-owned enterprises is that they are regarded as the economic cornerstone of CCP's ruling power. This idea is also wrong. Historically, the Chinese Communist Party took power before it built its state sector, not the other way around. If it had relied on its control of a large state sector, it would never have had the opportunity to rule the country. The CCP won the war against the Nationalist Party not because of its assets but because of its ideas. Even 100 percent state ownership of the economy cannot guarantee the rule of the Communist Party. The Soviet Union is a typical example. It collapsed when the state owned the whole economy. The

²²The Chinese Communist Party has the “*shuanggui* system” under which any Party member can be arrested by the CCP Discipline and Investigation Committee long before being legally sued.

CCP still holds its ruling power not because of the state economy but because of the rapid development of the private economy and the partial privatization of the SOEs in the 1990s. Today, because of the inefficiency and corruption of the state sector, SOEs have become a negative asset for the government. If the remaining part of the state sector can be privatized, the better economic performance might earn the CCP more public support.

Trap Five: Power Comes from the Barrel of a Gun. Mao Zedong once said that “power comes from the barrel of a gun.” This idea has become a deep belief of the Communist Party. The absolute control of the military is regarded as the essence of the CCP’s ruling authority, so any proposal to nationalize the military is strongly opposed.²³ However, if this idea were true, no political regime could have been overthrown, because the military forces were initially always in the hands of the ruling authority. Even the CCP could not have taken over power because in the 1940s the Nationalist Party’s military force was much stronger than the Communist Party’s. The Communist Party won not because of its gun power but because of the power of its ideas. Guns followed ideas. When ideas change, guns change hands. Many Chinese intellectuals turned to the Communist Party during the civil war after the anti-Japanese War, because they were dissatisfied with the dictatorship of the Nationalist Party and believed that the Communist Party would give them more freedom and democracy. The leaders of the Communist Party must realize that honoring its promise on freedom and democracy is more important than controlling the army.

Trap Six: An Unlimited Government Is Stronger than a Limited Government. The sixth wrong idea is that an unlimited government is stronger than a limited government. This idea has been a doctrine of the Chinese government for a long time, and China’s quick response to the global financial crisis seems to provide new support to it. The idea actually confuses authority with strength, and confuses strength with power. History has shown that a strong government is not an unlimited government, but a limited one. The reason is that a government can be strong only if it is trusted by its people. This can be well exemplified by the history of Great Britain (see Weingast

²³According to the CCP’s doctrine, the army should be controlled by the Party, not the state. Thus, the Chinese army is the Party’s army, not the nation’s.

1997). Before the Glorious Revolution in 1688, the king's government was almost unlimited. For example, the king decided whether or not to repay the government debts on time. As a result, it was very difficult for the government to issue bonds to the public. After the Glorious Revolution, the British government changed into a limited government under the constitutional monarchy. With higher credibility of the bond contracts, the capacity for the government to raise funds through bond issuing dramatically increased. A truly strong government is one under the rule of law, rather than under the rule of man. Limited government and democracy are like the commitment made by the government to its people. With these commitments, people can then trust the government, and the government becomes a strong one as a result. If the Chinese government cannot transform itself into a limited government, then it cannot become a truly strong government.

The Dangers Hidden in the Bureaucratization of Leadership

Apart from idea traps, China is facing a leadership problem. The principle of CCP's rule can be understood as that the 1.3 billion Chinese people contract the governance of the country to the Communist Party. The best way forward for the CCP is to find the best qualified "chairman of the board," "general manager," and management team to run the country ("company").

However, China has reached a point where its politicians are drawn exclusively from the political bureaucracy, whereas leadership and bureaucracy are very different. The top leaders are called "civil servants"—and ranked highest in the administrative order—and judges and justices are also defined as "civil servants." This is an absurd predicament. The bureaucracy follows carefully prescribed rules to ensure that mistakes are avoided, and therefore people who climbed up through this system are cautious and risk averse. Great leaders should care about the nation's destiny and future, and they must have extraordinary abilities to take risks and withstand the hardships of open political competition. It is very unlikely great leadership could emerge from the bureaucratic training process.

In China, the Party secretary is the head at all levels of governments, and the promotion ladder is strictly bottom-up hierarchical. Imagine that you were somehow appointed to a deputy head of a county government in China. How many steps away from becoming the county Party secretary would you be? Five! Each step takes at

least two years to complete. If you were lucky, in 10 years you could become the Party's county secretary. Once you hold this position, you become the true boss and might be able to undertake important things with full authority. But if you still want to progress up the political ladder, your next position should be a deputy mayor of a municipal government. Suppose you now become the deputy mayor and are still five levels away from being the city Party secretary, which would require another 10 years. Reaching provincial Party secretary from deputy governor of a province will take another 10 years. You can become a top national leader only after you hold the provincial Party secretary position for a few years.

At the end of this 40-plus-1 year process, those with courage and principles will probably have been knocked out, while those who chose to adapt themselves will have become thoroughly bureaucratized. At the end, we are left with a nation of bureaucratized leaders.

That is why Hu Jintao and Wen Jiabao were so weak in their leadership. It was the first time in the history of the Chinese Communist Party that the top leaders came completely from the bureaucracy. It is understandable that they lacked a sense of mission, vision, and courage.

The system as it now stands is incapable of producing great leaders at precisely the time when China needs great leaders for transiting China into a constitutional and democratic system. With the case of Taiwan, before his death in 1988, Chiang Ching-kuo recognized the importance of democratic institutions and began Taiwan's political transformation. The first generation of the Mainland Chinese revolutionaries had the power to create a similar transformation, but failed to do so. Even Deng Xiaoping missed his opportunity to become mainland China's Chiang Ching-kuo. After more than 60 years, China is still waiting.

Of course, we may not need to be so pessimistic. Owing to special historical circumstances and elite family backgrounds, China's new leadership team may possess the appearance of great leaders who have a sense of mission, courage, and the ability to lead.²⁴ It is because of this that I believe that the next 10 years present a rare window of opportunity to transform China. It is imperative that the new leaders do not miss this opportunity to embark on a political reform,

²⁴However, I must confess that I am still not sure if they have right ideas. As argued earlier, strong leadership with wrong ideas would be a disaster.

as future generations of Chinese leaders are unlikely to be as capable as today's without political reform.

Conclusion: China Needs a Free Market for Ideas

In this article, I argue that ideas and leadership play a crucial role in institutional changes. In particular, I propose a two-dimensional framework of ideas and leadership to analyze China's economic and political transition to a liberal society. I have demonstrated that the major progress in China was made during the first 25 years when the ideas were right and leadership was strong under Deng Xiaoping and Jiang Zemin. In contrast, the reform was stagnant and even had setbacks under the leadership of Hu Jintao and Wen Jiabao because they had wrong ideas. The future of China's reform will depend on the kind of ideas and leadership the new leaders, particularly General Secretary Xi Jinping, have. To succeed in a peaceful transition to a liberal society, China must get rid of the wrong ideas. Bureaucratization of the politicians is a big obstacle to the production of high-quality leaders. The future of China's transition is therefore uncertain and difficult to predict.

Can China say goodbye to revolution? The answer to that question will depend on luck. If China has good luck, then reform will bring us a constitutional government and democracy. If its luck is poor, then China might have another revolution, and no one knows what the consequences of that would be.

The question I have not yet discussed is: Where do the new and right ideas come from? A direct answer is to create a marketplace for ideas. It is the free competition in the academic market and the debate of different opinions, beliefs, theories, and ideologies that produce new and right ideas. I am not saying that the right ideas would necessarily win competition in the idea market. But if we want to produce right ideas and get rid of wrong ideas, the idea market might be the only mechanism we can rely on (see Dorn 2014).

The idea market in China is underdeveloped and heavily restricted because of the monopoly of the Communist ideologies. Nevertheless, Chinese economists and scholars in other social sciences have played important roles in the production of new ideas for the reform movement. This was particularly true during the first 25 years of the reform. The "debate on the truth's criterion" and the

“thought liberalization movement” were well-known for their breakthrough contributions to the startup of Deng Xiaoping’s reform (see Yang 1998: chap 3). In the 1980s and 1990s, almost every reform program was debated in academia before it became an official policy for implementation. The basic process works like the following: first, a few researchers proposed a new idea for reform that provoked heated debate; then it was accepted with modification by the reform-minded leaders; and finally it was integrated into the new policy and law. Without intensified academic debating, “the socialist commodity economy” would not have been written into the communique of the Third Plenum of the 12th National Congress of the CCP in 1984; private enterprises would not have been legalized by constitutional amendment in 1988; “the socialist market economy” would not have been recognized as the goal of the reform by the 14th National Congress of the CCP in 1992; and “the rule by law” would not have been replaced by “the rule of law” by the 15th National Congress in 1998.

My personal experience with the price reform may be a convincing example of how the idea market influenced the reform. By 1984, the urgency of price reform had already been well recognized by the top leaders. However, the dominant idea at the time was that major product prices must be set by the government, and that the government has the capability to set the right prices so long as it respects “the value principles.” With this idea in mind, price reform was treated as how to adjust prices administratively. The top leaders were waiting for the State Council’s Price Research Center to calculate the right prices. In an article I wrote in 1984, I argued that the right prices could never be set by the government and that the only way to solve the price problem was to remove price controls gradually through a dual-track approach (Zhang 1984; for an English translation, see Zhang 2015: Appendix to chap 12). My idea provoked a hot debate in an academic meeting in September 1984.²⁵ It eventually convinced a majority of the

²⁵This so-called Moganshan meeting was held in the famous resort site of Moganshan in Zhejiang Province, September 3–10, 1984. Participants at the meeting were young scholars from all over the country, selected from more than 1,000 applicants based on submission of academic papers. I was then a postgraduate of Northwest University, at age of 25, and the youngest participant at the meeting. The meeting was a start for young scholars to be involved in the discussions about economic reform.

participants at the Moganshan meeting. Soon the idea of the dual-track pricing system was accepted by the top leaders and then became an official price reform policy in January 1985. This was a change in the way of thinking. Without changes in ideas, the price reform process of China would have been very different.²⁶ If there had not been a free and open discussion at that meeting, it would not have been possible for my idea to influence policy.

The Chinese reform has also benefited from the idea market in the West. Just as China imported a great deal of technology and equipment developed in the West, it has also imported many ideas from the West. Without the ideas of Friedman, Coase, and Hayek, just to name a few, the Chinese reform would have been very different.

Ronald Coase was correct to argue that a free market for ideas is crucial for a peaceful and smooth political transition in China (Coase and Wang 2013). The Third Plenum of the 18th National Congress of the CCP produced a roadmap for reform during the next decade. Key ideas include letting “the market play the decisive role in resource allocation” and providing for “modernization of the governance structure.” However, if people are not allowed to freely debate how to reform the political system, then it will be impossible to develop the right ideas to implement this roadmap. Thus, there is every reason to be worried by the increasingly tight control of academic freedom and by the lack of publication and press freedom.

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²⁶For a detailed analysis of China’s price reform, see Zhang (2012b).

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