

Chapter 2

Theoretical Natures of China Institution Change

Strictly speaking, the theoretical study on China's phenomenon or the Chinese model involves essentially two major theoretical issues. One is the cause and mechanism of China's economic growth and the other is the motivation and mechanism of China's institution reform. Those two are so closely related and mutually restricted that most of the theoretical literatures about China always confuses them from each other and makes a circular argument of the causal relationship between them. The book emphasizes the difference between them with the intention of seeking a theoretical basis, so as to give the Chinese model or China's phenomenon an extreme but endogenous reasonable logic from the perspective of pure institution reform. That is to say, we will not involve the research on the mechanism of China's economic growth or the correlation mechanism between them.

The statement above implies that we will not answer the following question directly (not evading it): why is the essence of China's phenomenon the result of institution reform? Although the neoinstitution economics is committed to revealing the rational logic that the institution is important, in order to clearly argue that the institution is important and its reform contributes to China's economic growth, however, a more scientific method is to comprehensively and specifically investigate the internal mechanism of China's institution changes and its economic efficiency. This is because: firstly, only the efficiency concept has the legitimate and academic theoretical value of economics; secondly, the simple argument that the institution is important often contains a tendency towards metaphysical transcendentalism, and once it is applied in practice, the harm is disastrous.¹ That is, in order to distinguish the logics between China's economic development and the institution

¹The most intuitive realistic paradox is: earlier in 1990s, Russia had implemented the typical market economic system, but it fell into the situation of serious economic recession, rampant organized crimes and state-owned assets embezzlement rather than showing economic growth [see Wu Jinglian's direct assertion in *China Economic Reform* (P37)]. Later in the book, as one of the analysis conclusion, we will give corresponding discussions.

reform, we will focus on China's institution reform rather than the former. Briefly, the chapter will try to reveal the following three points through a critical review²: (1) the neoclassical economics has a congenital institution defect due to its ignorance of the political connotation of China's institution change; (2) the new institution economics lacks the profound characterization of the mechanism of institution reform due to the improper substitution of the concept of social cost; (3) the social choice theory misuses some theory paradigm due to its ignorance the bargaining logic of generalized transaction in institution reform. Based on the critical theoretical analysis, we may answer why the social change in contemporary China is a process of generalized bargaining institution reform, which is the purpose of the review in the chapter as well as the theoretical starting point of the book.

The following criticized theoretical outline just lays a foundation for understanding the bargaining logic of China's phenomenon from the perspective of institution reform, and further emphasizes that the institution reform theory may avoid or improve some defects of the three points of China's reform theories above. However, it does not mean that it is the only correct way to understand the theoretical logic of China's phenomenon, but provides a "new" statement for understanding China's social change and its internal mechanism.

In specific process of the review, we will keep the original problem of "what is the real cause of China's phenomenon" in mind to outline various explanations of China's economic theory of the three major schools. As for the references, foreign literature accounts for a large proportion, which is based on a concern for respecting the theory originality and the limitation of the book's space rather than underestimating or ignoring works of domestic theorists.

2.1 Institution Absence of Neoclassical Economics

The conception of the institution reform in sense of the book initially originated in the introduction of the market competition mechanism into the socialist planning system by Lange (1958) and his theoretical study of the Lange model. Earlier, Pooper (1945) and Hayek (1957), in the same sense but with different views, denied the philosophical value of the planned economy system as an institutional arrangement of the society in terms of epistemology—Due to the uneven distribution of knowledge and absolute incompleteness of macro information, there was no an almighty planning authority which could know all information about social resources and consumer utility and further formulate the social economic plan according with the principle of optimal configuration of social resources and

²As criticism does not mean complete negation, the correct arguments which are not involved in the relevant theoretical review will not be mentioned in the book. The critical statement of the theoretical review is the theoretical feature that all theoretical research should have, so it should be understandable.

welfare maximization. This should be regarded as the earliest prophecy of contemporary China's reform.

However, the problem is: which kind of human economic behavior is completely the unplanned result from the perspective of the realities in a family, an enterprise or a region? As Lange (1958) criticized, the individual decision making model itself of neoclassical economics could be regarded as a planning optimal arrangement of the economic subject based on the particular constraint. Enterprise boundary defined by Coase (1937) in terms of transaction cost also seems to imply that the enterprise is similar to an isolated "planning island" in the sea of market economy in essence. Within the boundary of the island, the enterprise is taken as an institutional arrangement to replace many subcontracts of the market with a general contract, which makes the enterprise employees take the initiative to abandon their freedom of job hunting and the production elements lose the freedom of fluxion in the market, but have to following the arrangement of the entrepreneur's "plan". At this point, the market economy in the theoretical sense is neither born the opposite of planned economy nor the criticism object of the planned economy theory in concept. This is because the essence of market economy lays in its social values of liberalism, which opposes only "individuals could be planned by others" and advocates the value of efficiency and fairness of market economy through a liberal social order of "autonomous decision making, independent operation, full responsibility for profits or losses and free access". The original concept of market economy does not (also cannot) deny the economic plan nature in any sense. A more profound problem is, the Chinese neoclassical economists should also note, that as long as the power in politics and its game equilibrium exist in the world, any economic behavior will be characterized by being planned to different extents in any realistic state, because the ideal of liberalism has been always living in the context of power and plan since its birth. Isn't it? Isn't children's freedom planned by their parents, and consumers' freedom planned by the producers, despite the counteracting forces? For that matter, the theoretical association between market economy mechanism and planned economy pattern by Lange model should be an important innovative theoretical attempt.

How to properly associate the market with the plan in theory on earth? With the gradual emergence of practical difficulties of the planned economy in the world due to its theoretical defects, Kornai (1980) focused on the phenomenon of shortage economy of the central planning system to study the micro-mechanism of the planned economy and gave the outstanding analysis of the causes resulting from the soft budget constraint: under the planned system, due to the lack of hardening budget constraint on the microeconomic subject, the enterprises had neither pressure of market competition nor motivation to make self decision and optimize the production. After the 1980s, the low efficiency of the planned economy directly led to China's economic system reform with the household contract responsibility system in countryside and the state owned enterprise contract responsibility system in cities as the primary. The practice, derived from the consciousness of pure local issue of China, essentially contains the reform connotation of the individual micro-mechanism of the budget constraint. And, the domestic scholars' debate in

china over whether planned economy or market economy should account for more at that time was just the vivid expression of the theoretical issue above.³ After 1990, with the advancement of the reform practice among China and eastern European countries, many scholars like Kornai (1980, 1994, 1995), Stiglitz (1998, 2006) and Rolland (1997, 2002) put forward the practice model distinction between China's institution reform and east Europe's social transformation, from the perspective of social transformation or economic system comparison⁴—the logic of gradual reform and radical reform, which was an key theoretical point.

The radical reform theory, which was the practical demand of reforming the planned economy system in order to cope with the debt crisis of Latin American countries after the 1980s according to the opinion of the international mainstream economic circles at that time, is often summarized as the ten economic reform policies of Washington Consensus (Williamson 1989). The core of Washington Consensus is no more than the concretization of the market economy theory of neoclassical liberalism. However, in the social choice of leaping from theory to practice, the economic advocacy of neoclassical liberalism is politically interpreted by the radical reformers with a philosophy of constructivist rationalism.⁵ They hold that: as an organic part of the general structure of market economy, three key elements of the market system, namely, property right privatization, financial liberalization, and price marketization, are all indispensable. Therefore, on the basis of emphasizing the hard budget constraint of property right⁶ and guaranteeing the macro-economic stability, they put forward the policy suggestion of “the shock therapy” with the one-time thorough reform (Kolodko 2000; Kornai 1994).

³Accurately speaking, it was the theoretical focus earlier in 1990' of China that people debated over the natures between planning and market based on the ideology. Later, it ended due to Deng Xiaoping's remarkable insight and with his popular discourse “both planning and market were the means”. As it is a well-known common knowledge among China's scholars, the book omits the statement of the related literature.

⁴There are two conventional terms in theoretical circle: social transformation theory and comparative economic system research. The former focuses on the idea of political economics, and the latter on the logical method of new classical economic theory. The academic tradition makes us classify them into the unified theoretical framework of institutional economics and new classical economics. The treatment of the book is to avoid a directional misunderstanding caused by the phrase of “social transformation”. The comparative research is easy to lead to a simplified theoretical dispute over the superiority and inferiority of social ideologies, which will be further discussed later in the book.

⁵The rational constructivism is the theoretical concept that Hayek was committed to criticizing. Domestic scholar Fuqiang (2001) and Maochun (2007) first proposed the associated view to China. It involves the classic content of the classical political philosophy. The details can go to their papers.

⁶Kornai (1980) put forward the concept of the soft budget constraint of economic agent according to the logical analysis of the socialist shortage economy and held that it was the microcosmic basis of the inefficient planned economic system. Thus, the hard budget constraint became the premise to implement the radical reform. It is Kornai's most important theoretical contribution because it is consistent with the foregoing logic how the market and planning are associated in theory. Here it is repeated.

But, the necessary logical premise of the constructivist rationalism theory is that the social institution can be formed through the construction of artificial rational design. Ironically, the logical defect of the constructivist rationalism was initially the theoretical starting point of Hayek, the mater of liberalism, to criticize the socialist planned economy in history. Today, it is misused by Hayek's faithful believers who try to apply it in the design of radical shock therapy, which will certainly bring some realistic social losses.

Further, the most essential defect of the radical reform theory is about the relationship between economy and political system in the social transformation. These neoclassical economists hold the belief that the reform of economy and politics should be the absolute separation, and that the constitution reform first, which reflects their misuse of the analytic philosophy but stubborn loveliness. Obviously, it is impossible to decidedly separate political institution from economic behavior in practice, so that the realistic reform with the comprehensive consideration of politics and economy is always preferred. Correspondingly, since the 1990s, even if China's economy has been improved significantly and grown fast and the radical reform of shock therapy has got into some difficulties, most mainstream neoclassical economists still deny the institutional connotation of China's reform process (Williamson 1989; Xiaokai 2003) and do not recognize the market economy nature of China's social change. They insist that: the institution reform must be a part of the constitutionalist transformation. China's reform without the superficial constitutionalist reform is more like the economic growth of a developing country in the conventional sense than the institutional transformation of the socialist system. If the relevant theories are simply generalized, three explanation arguments on China's economic model can be got. One is the natural economic growth process of a dual economic structure of the development economics in the traditional sense (Sachs and Woo 1996, 1997). The second is the optimal result of Keynesian macroeconomic regulation in the sense of national centralization (Stiglitz 1998; Hu Leming 2009). The third is the state capitalism model which means that the latecomers implement the catching-up strategy (Kurlantzick 2009; Raymer 2006).⁷ Of course, adhering to the theoretical logic of not recognizing the market economy nature of China's social change and further denying the political connotation of China's reform process (Susan 1993, Xiaokai 2003a, b), they inevitably doubted China's economic development and its sustainability (Williams 1989; Lardy 1998; Woo 1999; Sachs et al. 2003)⁸ and disapprove of questioning the long-term expectation of Russia's radical reform with the achievement of China's gradual reform.

⁷Lin Yifu's growth theory of the developing structure strategy has the same source as Kurlantzick's strategic theory of the later comers catching up the former ones, but he does not deny the political logic of China's gradual reform process. Because it belongs to the category of economic growth theory, the book does not detail it here but just points out the difference between them.

⁸Here, we quote the outstanding critical conclusion of Tianqi et al. (1997, 2000), but there is a fine difference with him. The related theoretical issues can be found in his papers.

In facing of the superficial contradiction between the mainstream economics and the reality of China's reform, the book raises a question: how to explain that China's reform is not a simple economic change process? Or accurately, does the social transformation happening in contemporary China have the necessary connotation of the evolutionary rationalism (Hayek 1960) in a sense of political order, which determined the market economic direction in the gradual process of China?

The initial theoretical answer came from the institution change theory, transaction cost theory, and property right theory of the new institutional economics. Relative to the theoretical defect of the mainstream theory in regarding the institution as the exogenous variable, new institutional economists with Ronald Coase, Douglass North, and Oliver Williamson as the representatives tried to incorporate the institution into the framework of the mainstream economics with bounded rationality and opportunism assumptions as the supplement. D. North insists in his institution change theory (1990) that "the key of economic growth lies in the core factor and dynamic mechanism of the institutional innovation", tending to consider the institution as an evolutionary process of some spiral movements of "equilibrium—non-equilibrium—equilibrium". If the initial position of institution is in the state of Pareto efficiency, the equilibrium of institution efficiency will be broken with the change of the social environment variable, such as the aggregate demand, technological innovation, political constructure and even lifestyle, etc. Thus, a new demand for institution innovation appears and eventually leads to institution change. Since the institution change is divided into changes of the overall social institution and the marginal adjustment of specific institutions like rules and norms, on this basis, many scholars (Susan 1993; Xianglin 2000; Yongnian 2001) attempt to demonstrate that: China's social change is the gradual evolution result of institution which contains both economic and political connotations. To understand the cause of China's economic growth, the key is to understand the institution selection mechanism under China's political environment. In view of China's constitutionalism problem worried by Xiaokai (2003a, b); Yifu (1994a) holds that: as a basic game rule, constitutionalism and its reform are also restricted by cultural traditions. It is also a long-term evolution process, and the key lies in the path choice of institution innovation.

To seek the optimal path of institution reform, the institution change theory holds when explaining the evolution process of socialism institution of Soviet Union and East Europe (Hausner and Jessop 1996) that: due to the establishment of the socialist system and its long-term existence in former Soviet Union and eastern European countries, the institution change has owned the characteristics of path dependence and path lock-in through the interaction between the increasing return and transaction cost of the old institution. At this point, the change of the increasing return mechanism of new institution mainly depends on the cognition and adaptive efficiency between official institution and social ideology. Further, it depends on the mutually dependent and constrained network effect between political institution and economic institution as well as the matching efficiency of institution innovation (Estrin and Wright 1999; Lundvall 2010). If the shock therapy of political change cannot form the new positive feedback mechanism for self-reinforcement of new

institution in the process of reducing the original institutional benefit mechanism, it will certainly bring the transformation cost in the privatization process⁹ and increase the sunk cost of the original institution as well. Obviously, it can be taken as the converse-negative logic of China's institution reform practice proposition, namely, the two costs of China's institution reform are lower, so it has an characteristic of efficiency.

Since the essence of transaction is the exchange of property right and the core of market system lies in its property right institution, in order to calculate the cost of institution reform in depth, the property right theory of institutional economics focuses on three sub-problems initially (Boettke and Christopher 2003): (1) the actual property right arrangement under the old institution; (2) new institution arrangement embedded in the market after the reform; (3) the influence of historical experience and cultural heritage on property right and its institution cognition. According to the thinking path of historical methodology of Schumpeter (1939), in order to understand the economic behavior and economic relationship of the multi-possibility open society, it is necessary to use the method of contextualization to analyze the social characteristics in the changing context. The market process of the property right and cost concepts in economics must be recognized in the way of being embedded in the society, so as to gain local characteristics. **Thus, the property right institution protecting the market transactions can only be explained under the specific historical and cultural background** (Zysman (1994): 130). After observing the debate of domestic well-known scholars in China over the reform of state-owned enterprises, we can find that the property right institution, which is used by Qiren (2000) to refute Zhang Weiyin's theory of "mechanism being important" (1995) and Lin Yifu's theory of "competition being important" (1995), is a complex system package containing both economic and political institutions rather than a pure property right concept. In other words, it is more a set of social ideology than just a set of ownership certificates. Later, Vernon Ruttan (2001) and Lin Yifu (2004a) attempted to compare the cost-benefit of the gradual reform with the radical reform in the realistic institution reform process based on the classification of induced and forced institution changes and held that a new institutional arrange would take place once the expected net income of the institution exceeded the expected cost.

Obviously, the mainstream economists of neoclassical liberalism misunderstand the political connotation in China's reform **because they ignore the role of informal institutions and the political nature of economic system itself**. In theoretical system, it is because the "selective omission" of the institution variables in the frame of new classical economics after Marshall leads to the lack of institutional analysis. In fact, Janos Kornai and Jeffrey Sachs were once the faithful follower of Hayek's thought, but their logical mistake of constructivist rationality made them

⁹The domestic scholars have similar statements, but because of the time lag and expression inaccuracy compared with the work of Estrin and Wright (1999) and Lundvall (2010), we only mentions the two foreign scholars.

attempt to act as a planner to advocate a rational plan design for the social transformation process.¹⁰ And this not only failed to fill the omission of the frame of new classical economics, but also increased the transformation cost of the reform.

2.2 Improper Substitution of the Transaction Cost Concept

Accurately speaking, the neoclassical economics after Marshall is not a theoretical system without institution variables, but contains a series of implicit premises, namely, the citizen consciousness, democracy and the related concept of legal system which have been gradually established and generally accepted in western countries after the enlightenment in the 18th century.¹¹ It is just based on the premise of ideal democracy and civil society that all theoretical goals and policy suggestions of neoclassical liberal economics are effective. That is why the above rationalism constructivist insist that “the constitution reform first”. This implies that the book faces a new question: how to realize the reform of informal institutions and even the social system in a social environment without the premise?

Unfortunately, the new-institution economics theory has no theoretical description of the institution reform itself.

Why does not the huge international influence of new-institution economics bring forth the theoretical fruit along with the practice of China’s economic institution reform? Except putting forward the epigram similar to “the institution matters” (in Coase’s words), why dose it not give us more enlightenment on what institutions will “matters” better and how to establish the institution? Although its criticism on the neoclassical economic is penetrating, why is it always questioned or criticized by the mainstream economics? The reason is that the new-institution economics makes some improper logical substitution of the institution concept with the transaction cost concept, which results in the absolute gradual logic of the institution change.¹² In fact, Ronald H. Coase is a genius, but he mistakenly uses

¹⁰Although Kornai once said that to what direction the reform develops and to what extent it can develops are based on various conditions. Thus, the economics in socialist countries should carefully study and push the reform rather than meeting people’s illusion with the reform scheme which is difficult to realize. But, in fact, it was because Kornai first proposed the classification of the gradual and radical ways in his book *the Road to Free Economy* that some unnecessary disputes in the theoretical circle and various phenomena in the reform practice appeared. He also said after discussion with Sachs, the originator of the shock therapy, he believed more that his suggestion was correct. Here, the book just emphasizes the tendency of his thought.

¹¹On the misunderstanding to the problem, the excellent criticism and profound insight of the Chinese economic theorists can be found in Gao Quanxi’s article [2010]. Section 7.2 of the book will have an extended discussion based on the analysis of China’s institution reform context.

¹²The book’s logical criticism on the path dependence principle does not mean a denial of it, but a description of the misuse of the path dependence in the theoretical context of the institutional reform. It will also be stated later.

the cost concept to reveal a phenomenon that people turn a blind eye to—economic behavior is closely associated with political institution. However, once we analyze the institutional logic with the cost and even institutional cost concepts, we immediately fall into such a theoretical dilemma: as the result of sum and equilibrium of social behaviors, the existing institution is the optimal social choice of people's behavior and a contract arrangement which is more efficient than any other institutional choice. At this point, the measurement of the maximum returns of choosing other institutions rather than this one according to the definition of the concept of opportunity cost in economics has lost the legitimacy in any sense. In reality, people make improper comparison of economic performance or political ethics between one institution and the other because they ignore the equilibrium logic in the institutional concept.¹³

The book arbitrarily criticizes the institution analysis logic of the transaction cost concept for two essential reasons: (1) the historical analysis of institutional economics; (2) the overall value theory of institutional economics.

In the middle of the 19th century, the German historical school with F. Liszt as the pioneer rejected the abstract and deductive naturalistic analysis of British classical philosophy and advocated the specific and empirical historical method initially, which promoted the rise of the American institutional economic school with T. B. Veblen, J. Commons and W. Mitchell as the representatives in the late 19th century. To study the role of institution or institutional factors in the social economic development from the historical perspective, it was necessary to take the relationship of peoples as the starting point rather than the relationship between human and objects as the logical basis. Therefore, the institutional economic school keenly attached great importance to the analysis of non-market factors, such as law, history, society, ethics and other generalized institutional factors, and emphasized that those non-market factors were the key causes affecting the social and economic life. Since the 20th century, the institution change theory with North and Robert (1973) and Schultz (1967) as the representatives further clarified that: the market function was important among many factors affecting human behavior, resource allocation and economic performance, but the failure of market mechanism rooted from the imperfectness of the fundamental institution ensuring the market transaction. At this point, the analysis of economic performance must be based on the institution concept. The famous principle of "path dependence" was an example of the vivid logical expression of the argument. The most insight of the institutional economics may be that: it explained all basic concepts that the market economy relied on were the results of evolution of specific social institution, and those concepts themselves had the nature of institution. Later, Zhang Wuchang, Demsets (1988) and Williamson et al. followed the classical exposition of Coase (1960) to

¹³ More strictly, both economic performance and political institution are the results of the equilibrium of a certain kind of people's behavior. Here, the concept of the equilibrium set means the aggregation of people's social behavior, namely the logic that everyone has to behave like it of + which is a optimal social contract that people understand and voluntarily follow to, so we cannot compare the cost-benefit of one equilibrium to another.

refine the fundamental institution of market into property right, contract and other concepts, thus deepening people's comprehensive understanding that the market system itself were the devices of institution.

The overall value theory of the institution school also has a long history. The initial theory emphasized that: economic analysis must focus on the overall value of the society, including not only the economic indicators like GNP but also social equality, eco-balance and people's leisure pursuit. Superficially, Coase (1937) made the cost analysis based on the marginal utility of individualism in his famous paper, which seemed to have nothing to do with the overall values, but the transaction cost concept itself was the sum of profit and loss of the common behavior of both sides of transaction in essence—railway company & wheat field owner, and wheat planting farmer & cattle farmer.¹⁴ The method based on the overall value—"if the transaction cost (sum of both sides) is zero and the property right is not important",¹⁵ has been fully reflected in Olson's famous *the logic of collective action* (1965). He claimed at the beginning of the book that the premise of his theory was the collective interest. Later, Galbraith (1976) more explicitly put forward the concept of overall institution goal and directly criticized that macroeconomics and microeconomics of neoclassical liberalism paid attention to only the adjustment of the level of aggregate demand and the formation of the price, respectively, but omitted or ignored the institutional structure of the society, namely, the issue of power structure.

In essence, the historical empirical method acts just as the Father History to evaluate the institution status while the logic of transaction cost or social cost acts as the chief accountant of society to calculate the institution operation. Due to the collectivism methodology tendency, the institution school is committed to measuring the relationship between institution and economic behaviors from the overall value and tries to abstract a normative concept equal to efficiency and rationality from economic behaviors and institution phenomena. In this context, individuals can only be the sub-concept of society, politics and organization, which is inevitably incompatible with the academic tradition of individualistic methodology held by the mainstream economics. In other words, the concept of transaction cost actually opens a right door to the research of the institutional theory but leads the theoretical path of institution research to an error direction due to the congenital defect of its logic.

Let's return to the observation of the theoretical explanation of China's institution reform in the book. According to the theoretical logic of institutional economics, the institution, as a social contract arrangement which can reduce

¹⁴It just reminds readers of recalling Coase's case analysis to explain the argument.

¹⁵It is the famous Coase theorem which has several versions. The description here just wants to highlight that the confirmation of its basic concept must be based on the observation of the overall social behaviors to calculate the transaction cost from a non-strict collectivism methodology or overall value concept—obviously, the so called "institution cost" is ignored by the traditional new classical economics but appropriately revealed by the new institutional economics in an inappropriate way.

“the generalized transaction cost”, is the constraint collection of people’s social behaviors (North 1981), in which the interdependence and mutual evolution of formal and informal institutions play a pivotal role in the formation of the market economic system. As the institutional cost concept is improperly used, and the three of ideology, formal and informal institutions contain the complex interactive relationship among faith, organization, values and accidental factors which cannot be fully understood by us till now, in the context of the new institutional economics, the institution change in their view (Keefer and Shirley 2000: 104)¹⁶ is only a marginal and gradual process which is full of culture blending, slow informal institution accumulation and gradual formal institution reforming. Prof. Zhou Qiren once attempted to prove China’s rural reform by using the logic of absolute gradualism.¹⁷ The key argument he used was: numerous tails of capitalism such as the private plot existed even in the absolute planned economy system. The book cannot deny this point. However, Prof. Zhou forgets a simple fact: if there was no the typical event of private contracting in Xiaogang Village and it was not reflected to the Party Central Committee as a generalized bargaining behavior strategy, we could not expect the seedling of capitalism to grow into a big tree of market economy even after one hundred years. This is because the difference between the empirical institution and normative institution cannot prove the gradient logic; otherwise, the bandits have existed for hundreds of years in Xiangxi, but they do not affect or cannot alter the change of social institution even in local regions from Qing dynasty to the Republic of China and to the People’s Republic of China. Here, we must pay attention to the key events and context equilibrium in the process of institution reform. Obviously, once the absolute gradual logic of new institutional economic school ignores the equilibrium logic of games in the realistic institution reform context in theory, it cannot contain the rational design wisdom that is the typical political behavior of human beings in the institution reform. That is, the final theoretical guidance of institution economics contains the logic defect of absolutely denying the artificial political wisdom of human rationality (Buchanan 1989, pp. 77–196).

If we compare China’s traditional political history of economic and social evolution for thousands of years to a kind of social path selection, the gradual logic that “path is shown up only when thousands of people walk through”¹⁸ should face

¹⁶Due to the huge influence of the work of Keefer and Shirley (2000)—similar to ending the gradual reform theory of institutional analysis, here, the conclusion statement of absolute gradual reform logic of it is also based on it. Many domestic new institutional economists have quoted it unanimously and unequivocally and used it for various context analysis of China’s reform, so we direct quote it without more narration. The details can be found in their paper.

¹⁷The statement to Prof. Zhou Qiren’s view was mainly from his answer to my related questions when I listened to his lectures in China Center Economic Research of Peking University during 2003 and 2006 without direct text or related paper. Since I have no chance to consult him since then, the mistakes have nothing to do with him.

¹⁸The Chinese thinker Lu Xun’s logic about “path” and Deng Xiaoping’s logic of “crossing the river” about China’s reform are cited here to imply the difference of the social evolution process between “walking on the path” and “crossing the river or bridge”. It is just a visual statement.

the questioning of the elitism which believes firmly in the mechanism design theory that though the road can come into being through walking spontaneously, the bridge has to be designed and built by people. The scientific conclusion of the mechanism design theory just shows that: when the constraint conditions of incentive and participation are compatible with all participants, the rational mechanism design can also form the social order in the equilibrium sense (Hurwicz 1972; Maskin 1977, 1980; Myerson 1979, 1983).¹⁹ In fact, we cannot deny that each reform process of each institution in China's social change is full of the rational wisdom of political elites in its reform practice known as "wading across the stream by feeling the way". At this time, the reform of rural household contract responsibility system and even the broader reform of the fiscal and taxation system are almost the result of radical reform based on the rational wisdom design of the political elites. It means that a great theoretical contrast exists between the absolute gradual logic and the basic fact of China's reform practice.

Obviously, the reason for the simplified confrontation of the inherent logics between gradualism and radicalism by new-institution economics is that the new institutional economic theory lacks the specific description in context of the social institution change under the constraint of path dependence. Without the details of contextual rationality, it is impossible to explain how China gets rid of the path dependence for thousands of years in the environment different from "*the Rise of the Western World*"²⁰ and how it can walk on the road of gradual reforming to the market economy at the end of the 20th century.

2.3 Paradigm Misuse of the Social Choice Theory

Relative to other explanations of China's economy, the most important original contribution of the theoretical study of contemporary China's reform should be the analysis of social choice theory with Fan Gang's analysis of "the gradual reform" as the representative and insightful theoretical judgment (1993). Simply speaking, Fan Gang's gradual reform concept itself is the bargaining strategy formed through the conflicting compromise of the social contradiction between reform and anti-reform in the traditional ideology. To explain the association, also because this explanation of China's mode should be the only theory with the most important value,²¹ we will make a logic interpretation with critical thinking next.

¹⁹This is the main conclusion and classical logic of the mechanism design theory. The relevant content can be found in general teaching materials. Here it is only quoted from the perspective of this book.

²⁰We use the title of D. North's book to vividly narrate it here. It is just a convenient analogy.

²¹The development strategy growth theory (Lin et al.) of the development economics is also committed to the similar theory goal. Since it involves in the circular argument of the relationship between economic growth and institution reform, according to the premise explanation of the chapter, it is outlined here.

Fan Gang's paper in 1993 entitled "*Public Choice and Reform Process*" comprehensively puts forward the theoretical definition and practical judgment of the gradual reform. Different from the marginal method of mainstream economics with Janos Kornai as the representative or the general logic of new institutional economics, Fan Gang's way of thinking originated from K. Arrow's social choice theory (1963). As the behavior aggregation of ordinal utility makes the calculation of social choice possible, it tries to give the specific description of the path dependence in the social choice of China's reform. This lays it the foundation of full academic legitimacy. And, the intuitive attribute of the theory makes it become not only the important assertion associating with China's political economic institution reform but also an important part of Beijing Consensus (Ramo 2006) with the international influence.²² According to Fan Gang's calculation, when people face three simplified schemes of social choice, namely, radical reform, gradual reform and anti-reform, the second one is a rational choice with the approval of the majority. As for the theoretical logic under the majority rule in contemporary China, Fan Gang and his followers do not make a thorough investigation.

In theory, the gradual reform theory is the control evolution theory based on the elitism thought.²³ It implies that the reform progress should be rationally controlled without losing the moderate stability, which objectively denies the choice of radical reform. As for the logic and cause of denying the radical reform, most literature does not answer why it is gradual reform rather than radical reform that benefits China. In fact, the most possible intuitive logic of gradual reform lies in two aspects. One is to apply the method of trial and error in the natural science to social choice behavior. In the face of the veil of ignorance, i.e., what topics the social choice will face and how to calculate the political transaction, it needs the innovations of the trial and error to reduce the cost of social reform indeed. The other is to create the space buttering the social choice contradiction and the stable social environment through the gradual way in the reform process, so as to avoid the social breakdown after contradiction intensification.

However, the relationship between the essential connotation of the above logic and the gradual reform proposition is open to discussion. The trial and error method originating from the scientific research has brought great benefits to the industrial revolution. It has made people get rid of the natural and passive production mode of agricultural economy. With the characteristic of industrialization, the essence of its methodology is to seek more good solutions with the minimum cost. Actually, the solution quality is proportional to the number of experiments. At this time, if the

²²The general expression and detailed discussion on Beijing Consensus can be found in J.C. Ramo's book in 2006. Although it is not a pure interpretation of the political economic theory, due to its huge popular influence, it has received much attention.

²³It should be noted that despite both claim the gradual reform, the control evolution theory based on the elitism thought has the essential difference from the absolutely gradual social evolution logic of the foregoing new institutional economics in the theoretical starting point. It is the contribution of Hayek (1957) who was committed to distinguishing and classifying criticisms. Since the related discourse is not the key point of the book, it is briefly introduced here.

social choice has a docking point similar to the scientific truth²⁴ without being influenced by social values, what the society needs is faster and more “experiments”, having nothing to do with whether the single experiment is gradual. For this reason, Deng Xiaoping once put forward the methodology of “wading across the stream by feeling the way” on one hand and the reform requirement, on the other hand out of a politician’s intuition, of “being more daring in reform and opening up and quickening the pace of economic development” and “striving to reach a higher level every few years”. The success of the rural household contract responsibility system is a proof of it. That is to say, the methodology of “wading across the stream by feeling the way” is not the direct deduction of the gradual reform.

Secondly, there is indeed the kind worry that conflicts lead to social collapse in reality. As the social choice issue is the embodiment of social conflict, it is normal to worry about the social cost of conflicts resulting from the reform. But the question is: if the gradual way of reform can alleviate the conflicts, not the reform scheme can solve the contradiction and resolve the conflict, the task of social choice becomes extremely simple and the calculation of political transaction is not worth the trouble. And what is needed is to slow down the reform which is felt radical subjectively. What is the reasonable speed of gradualism? In reality, the users of the gradualism theory bring up a high-sounding reason of the degree that people can accept. However, the false pretext hides a contradict premise: the mass seem to be the opponents of social change, which is inconsistent with the common sense that the harm of the majority’s interests by the powerful minorities always leads to the demand for social reform.

Actually, the conflict pressure faced by social choice mainly depends on the solution to the conflict. I do not rule out that the acceptability has the external characteristic of gradualism to some extent, but it is not essential. The essence of the reform scheme is the transaction containing the social interests conflict against or compromise from each other, and the key of transaction is the content. Once social choice reaches “the calculus of consent”, even if the calculus result is the radical reform with huge changes, its social conflict pressure is still the smallest; on the contrary, if the conflict is enlarged, even if the tiny reform may cause social unrest. Furthermore, due to the continuous and interactive characteristics of the social choice process, the one-sided emphasis on the gradualism of reform based on the speed will easily cause the ignorance of the reform content and thus form extra reform cost.

Thus, the gradual reform logic simplified by social choice cannot deny the reasonable connotation of radical reform but is only an intuitive description after the observation of China’s reform practice. The reason for it is the defect of Fan Gang’s academic basis—social choice theory itself. In fact, the social choice theory directly

²⁴It applies the metaphor that the political philosophers strongly opposed. It shows that the social choice theory faces many problems like the difference between general institution and constitutional institution, their origins and functions when dealing with related theoretical issues. Limited to space, it cannot be extended.

abstracts the comprehensive factor of politics and economy to the topics coming from the social choice issue, and extends the individual behaviors based on ordinal utility to the sum of collective behaviors of social values through investigating the choice logic of collective voting in the realistic political behavior. The extension is the core that the social choice theory created by Arrow (1963) which differs from the logical paradox of Condorcet (1785). Although Arrow's social choice impossibility theorem draws the contradictory negative conclusion, it does not reduce its great contribution to the political economics in normative theoretical analysis.

However, in order to explain the ideological transformation and even reform of the Chinese society, when Fan Gang uses the theory to investigate China's social choice logic among reform, anti-reform and gradual reform and gets the conclusion that the gradual reform in contradiction obtains the consent of the majority, we are faced with two logical difficulties. Firstly, how does the reform issue with the democratic value itself produce and why does not it appear in the previous social choice objects? This is the logical starting point issue of social choice theory.²⁵ If we admit that the premise of Arrow's social choice must depend on the democratic election institution in traditional sense, in order to adopt a generalized social choice concept to explain China's reform, a simplification close to reason in China's sense is that social choice is a series of social process with mutual association—people choose the representatives, the representatives choose the issues, ...²⁶ and finally a process of social choice through the people's congress system and the system of multi-party cooperation and political consultation under the leadership of the Communist Party. But it leads to the second question: what's the interest, logical and institutional relationship among people, representative and issue? The book insists that the Communist Party of China is the only, long-term and loyal representative of the Chinese people's interests, which is the historical assertion based on empirical study. However, the further question is: how do the people in different interest groups realize the conflict harmonization and transaction compromise of different interests through different representatives within the communist party? Obviously, even if the social welfare function based on the ordinal utility contains the comprehensive variable of political and economic factors and its calculation, it is unable to complete the utilitarian calculation and its transaction of social choice. This is because that the abstraction of the complex social choice process to the one-off voting logic inevitably ignores the dialogue logic of the normal democratic election process and its bargaining mechanism as well as the cost calculation of the generalized political transaction of course. Buchanan once made a pertinent comment on it: "public choice is a kind of view of politics. It is produced by expanding the tools and methods of the economists to the collective or non-market

²⁵The direct expression of the problem involves the debate between Arrow and Buchanan.

²⁶It quotes Buchanan's criticism on Arrow [1989] and adopts the continuous choice concept of logrolling calculation in Buchanan's sense: due to the contradiction of the budget issue, only through the exchange of your agreeing with my bill this time and my agreeing with your next bill, can the public choice be unanimous. It is just a brief statement. The details can be found in Chaps. 6, 8, 9 and 10 of *the Calculus of Consent*.

decision making. However, the statement does not give full description, ... , because we must focus on the origin, ownership, and institution of the generalized transaction in order to get the view of politics”.²⁷

Back to the observation of contradiction in the trinity of “reform, development, and stability” in average Chinese society, since no any reform process just involves three fixed issues, people will not be so foolish of staying at the three topics of reform, gradual reform and anti-reform that get into the trouble of theoretical circulating of some logical contradiction. In reality, people want the incremental benefits of development, the variable returns of reform and the constant gains of stability at the same time. The realistic rationality forces people to search for various issues and their transactions. **The development gains can make up for the reform loss and guarantee the stability as well.** If the collection of social choice issues cannot go beyond reform, gradual reform and anti-reform and reflect the objective state of the real practice, the theoretical conclusion of the social choice inevitably has the logical deviation. Only the accurate issues of gradual reform can ensure the success of the reform. And, the reform content and its equilibrium appropriateness are the key, regardless of the reform speed. That is to say, the social choice theory cannot fulfill the theoretical explanation task of China’s reform practice, and the gradual reform theory is just an intuitive statement about China’s institution reform rather than the true proposition of China’s reform.

Why does the book turn back to criticize the gradual reform logics of the new institutional economics and the social choice theory after criticizing the radical reform theory of rational construction of neoclassical economics? The reason is that we must get rid of thought constraint of the law of excluded middle—either radical or gradual reform, which is the same blind theoretical point of those three.

Aware of the defects of the gradual logic of social choice theory, Gang and Yongtai (2005) put forward the reform model of parallel advance later and held that the social reform efficiency depended on the constraint of mutual influence and precondition among different sub-institutions. Due to the role of unbalanced cost—the sub-institutions with slow reform become the bottleneck of others and those with fast reform cause the chaos of prematurity, there must be the optimal reform designs based on different speeds among the sub-institutions. Obviously, it should be the theoretical improvement of the recent analysis of China’s institution reform worth affirming (due to the space limitation, it is briefly introduced here).²⁸

²⁷The view was come from Buchanan’s criticism on the ignorance of the political deal calculus by the social choice theory in Arrow’s sense. The details can be found in his book (1962) and his earlier papers in 1954 and 1959. Most of those papers were collected in *Calculus of Consent and State, Liberty and Market* co-authored with G. Tulloch. That’s also why Chap. 3 introduces social choice first and public choice next.

²⁸In his paper, Fan Gang made the calculation of the optimal planning through the social welfare function $W = \alpha \left\{ \sum_{i=1}^n x_i \right\} - \beta \left\{ \sum_{i=1}^n \sum_{j=1}^n (x_i - x_j)^2 \right\}$ (in which α was the benefit coefficient of institution reform; β was the conflict coefficient; $x_i \in [0, 1]$ was the institution reform item; 0 meant no reform; 1 meant the reform has been completed).

In fact, if we put our concern on the main reasons of China's economic development, we have to admit that the key lies in the market economy with institution reform as the forerunner and its related mechanism. As a result, China's institution reform and economic operation mechanism in 30 years become the first step of our in-depth analysis. The task requires China's theorists to adhere to the thinking method of classical political economics in Smith's sense. We need to not only calculate the economic interests of social behaviors and consider the political logic of the social process, but also analyze the top-down social choice and calculate the generalized transaction. That is, in order to get insight to China's mechanism of institution transformation and fully understand the true story of contemporary China's social change, it is necessary to focus on the specific process of the generalized transaction behavior of human society and deeply calculate the cost of social choice. At this time, a fruitful method of economic theory is the bargaining game analysis. In short, it is to regard the institution reform plan as the signing process of a specific social contract, in order to observe the game equilibrium of the generalized bargaining in social politics and its solution concept. Rubinstein (1985) once said: our society is full of bargaining processes. The so-called social behavior is just people's rational tradeoff between the game cost of bargaining and the negotiation gains. K. Binmore pointed out: "a mature society must be full of fairness However, in face of the new challenges emerging constantly in the society, fairness, freedom, and even all social norms must be constantly adjusted and reformed." (2005, p. 187). Since the only way for people to reform the social norms and objective institutions is the bargaining process of political transaction in reality, as the core mechanism of human society evolution, the generalized bargaining behavior is entitled to some profound connotation of "social programming" (in Binmore's words).

An intuitive understanding about the bargaining context is that: in numerous game categories, only the bargaining game has the most obvious dialogical nature in social interactivity behavior. This is because once facing any institution behavior from your opponent—similar to an offer, if you have no objection, it means you have agreed with and accepted it. Then, numerous and long-term accumulation of the similar offers will finally cause the offer collection to evolve towards the institutional provisions and norms which are associated with the social behaviors of both sides. On the contrary, if you totally or partly object it, any of your proposals—a counteroffer, similar to a new institution proposal, may be balanced and established.

Thus, the bargaining dynamic process is the most direct and essential game description of the institution behavior. In theory, the formulation of it is the problem discussed and solved by the simplified separation of "Divide-Choose Game" from "Moving-Knives Game".²⁹ In reality, the bargaining logic is quietly hidden in all

²⁹Similar to the ultimatum game, Divide-Choose Game is a generalized reflection of the program separation of the bargaining game. It is usually expressed as the process of "you distribute, and I choose in turn"; Moving-Knives Game is a generalization of the time discount separation model of the bargaining game. It is usually expressed as the game process between a complicated distributor with a knife and a chooser shouting "stop".

aspects of social behaviors, such as between husband and wife, father and son, leader and staff, government reform leader and participants, and even rulers and the people apparently. We must abandon the thought restraint of some absolute ideology; otherwise, the rigid way of thinking will hinder not only our in-depth observation of the practice phenomena but also the research perspective of theoretical innovation.

Parse of China

Gradual Reform Logic Based on Bargaining Game

Tong, Y.

2017, XIX, 258 p. 41 illus., Hardcover

ISBN: 978-981-10-4477-9