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COASE'S HERITAGE AND CHINA'S FUTURE

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[The import of this eulogy of the recently deceased English economist Ronald Coase is that China should rely more on the market mechanism. The essay is a dissent from the dominant view among the authorities stressing the primacy of the state-owned firms: state-owned firms geared toward making profits, which then become a source of wealth for those managing the firms. Although the state firms operate in the market, they also enjoy “soft-money constraints,” that is, access to state funds or guaranteed loans to cover losses, giving them an advantage over private businesses. In a free-enterprise economy the general case for state ownership concerns collective goods—goods that must be enjoyed by all if they are enjoyed by any. A classic example is lighthouses: a lighthouse cannot be tailored to shine only for those ships that subscribe to its services. Since any ship in the vicinity gets the advantage of the lighthouse whether it has paid for it or not, no ship or shipping company has the incentive to buy the service and there will be no money to provide the service. One solution is to have the government operate the lighthouses, collecting the necessary funding through taxation or some other coercive method. Coase found, however, that many English lighthouses were in fact privately owned and operated, and were paid for by port fees levied by local authorities on ships using nearby harbors. In other words, government ownership is not always necessary even for the provision of collective goods. Critics point out that this still required government involvement; and other critics claim that privately-operated lighthouses did

not in fact remain in business for very long. Be all that as it may, the main concern of the author of this document is the ownership of land, which is not a collective good. Farm land in China technically is still collectively owned, rented out to farmers on long-term leases. But the farmers do not own the land they farm, and the land can be confiscated by local authorities who find more profitable uses for it. The author advocates land ownership being transferred to the peasants themselves, allowing the peasants greater security and flexibility.]

The Nobel Prize winner Ronald Coase, aged 102, departed this real world, the central concern of his life on September 2. Like many other first-rate scholars, this perfectly-mannered English gentleman always had friendly feelings and warm expectations concerning China. This was the subject of his last work of scholarship, *How China Became Capitalist*. His choice reflects the importance of China's economic and social changes for the future of the human race.

Reflecting on the heritage Coase left behind gives rise to a series of questions. Perhaps Coase's theories provide some insight into these questions; and perhaps we also need to continue with our own arduous explorations. Without a doubt Coase's most important thought concerned explorations of the nature of the firm. In "The Nature of the Firm" he demarcated the distinction between the firm and the market.

Action in both the firm and the market involves transaction costs. In the market costs are incurred in gathering information, bargaining over prices, setting of time constraints, stipulating contracts, fines. But the firm also incurs costs: costs for advertising for employment, testing and assessment, training, supervision, and severance. Therefore, the cost of any commodity or service used by the firm that is acquired through the market is

set by the market. Otherwise, it must be produced within the firm itself. From this we can judge that as the firm grows larger there will be diminishing reliance on transaction costs.

However, when we observe Chinese economic growth, we are faced with a very awkward problem. Over the past many years state-owned firms, contrary to what theory predicts, have not gradually withdrawn from the market. Rather, impelled by the market mechanism, it is private firms that have been retreating step by step. How is it that state-owned firms, with their relatively high transaction costs, are able to enjoy a market advantage in China? We believe that Coase's theory must include additional institutional constraints if it is to explain Chinese economic phenomena. We see among these the mutual relationship between large-scale investment of public funds by the Chinese government and the large-scale investment undertaken by the state firms themselves. The combined purchases by the government and the state firms set a series of thresholds that will exclude the products and services of the private firms from the market. Thus, the huge amount of investment in China does not promote the rapid development of private firms, but on the contrary allows the continuous expansion of state firms despite their high transaction costs.

The next question is whether this is a short-term phenomenon or a long-term condition. To answer this we must look into the where the basic impetus for economic growth comes from. Whether in China or abroad, the core of economic innovation lies in competition. An environment of low transaction costs is a necessary condition for innovation. A bureaucratized management is the greatest deterrent to creativity. In state firms innovation is a task imposed on the firm from the outside. Innovation is not something intrinsic to the firm itself. Therefore, in space flight or other fields where there

is no need to count costs, state firms can make progress by responding to the demands of the upper levels. But in commercial aviation or construction there is nothing good to be said about this method. The reason is that in the former requires cooperation from materials, financial, machinery, equipment, electronics, and other bureaus. Without the presence of the market mechanism, innovation can be undertaken in accord with administrative directives. But in China's commercial aviation the high level of transaction costs makes this sort of innovation difficult.

Therefore, China's economic development must move in the direction of lowering transaction costs. To achieve this we must reverse the direction of China's ever-increasing bias in terms of financing and taxation toward state firms toward policies supporting the development of private firms. Otherwise, the bureaucratized style of management will lead to ever-increasing transaction costs, putting a drag on China's innovation and economic growth.

Coase's world-changing contribution was his theory of externalities. This theory is also relevant to whether or not we require government participation in the market economy. The traditional view is that it is hard to provide for certain public services through the market—for example, roads, controls over pollution, lighthouses, so forth. Therefore, private firms will not provide these services. It is necessary, rather, to rely upon the government. A consequence of this outlook was that government tended to grow larger and larger. Government programs grew ever more numerous and governmental involvement in the economy became increasingly evident. However, after Coase studied the history of British lighthouses, he came to disagree with that traditional understanding. He thought that if there were a clear definition of property rights, a competitive market

could resolve the problem of externalities. That is to say, we don't need the hand of the government; what we need instead is to keep on perfecting the market economy. The most important way of doing this is through the definition of rights to participation in the market.

In thinking about China's future, the most urgent problem is that of the three rurals.¹ To resolve this, China needs to undergo a new land reform. At the start of reform and opening China opted for what was the spontaneous demand of the peasants, for a mechanism of the distribution of surplus agricultural production based on a system of agrarian land contracts. This played a great role in stimulating agricultural production. The establishment of a firm right to dispose of the surplus had a profound effect on China's agricultural development. But agrarian reform was strangled by the question of ownership rights over land. Because China has a system of collective land ownership, the beneficiaries of the rising value of land have been primarily the government and development companies. There has been very little benefit to the peasants. So, then, where is the motive for the further development of the Chinese countryside? It's impossible to rely purely on government investment. And peasant income from agriculture and from part-time work is not sufficient to allow large-scale capital accumulation.

In the face of these impossibilities, it is necessary to think about what is possible. At a minimum peasants should be given the right to transfer land. On the one hand, if the income from the land accrued to the peasants, the peasants could accrue income from capital, not simply from labor.

¹ 三农: issues pertaining to agriculture, rural localities, and farmers.

The best choice for the state is the accumulation of wealth by the people. If the firm control over land usage by the government is not released, it will be very difficult to get any endogenous impetus to agrarian development. Previously we established the right to make contracts. Reform hereafter must establish rights over land, especially the right to transfer land ownership and to derive profit from land.

Coase has passed away, but his lifetime of creative scholarly contributions will continue to inspire China's economists, especially in their endeavor to analyze China's economy in a practical and rational manner. China's future depends upon our ability to think in a way that penetrates into practice. In that sense Coase has not gone very far away; his lighthouse continues to guide us.

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