

# Is Mainland China Evolving into a Market Economy?

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*An assumption has often been made that when the economic transformation of the People's Republic of China (PRC) and other former command economies is complete, a market economy will be the end result. This article explores the validity of this assumption. While the transition process in the PRC has not yet reached a stable equilibrium, the evidence to date suggests that a set of institutional arrangements may be evolving which characterize an economy based on "licensing and regulation" rather than market forces. Economies based on licensing and regulation are characterized by endemic corruption, poorly defined property rights, and high transaction costs. Over time, high transaction costs stifle economic growth while vested interests in corruption act to prevent further progress toward a market economy. Unless these new vested interests in the PRC can be induced to further liberalize the economy and improve property rights protection, the level of economic development may fall far short of its potential.*

**Keywords:** economic transition; property rights; transaction costs; China; markets

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The impressive economic growth that the People's Republic of China (PRC) has experienced over the last fifteen years has enticed the world to examine this "new" Chinese revolution for the secrets of its success. However, this "new" revolution has not been subjected to the same degree of scrutiny as the "old" Maoist revolution and a large number of fundamental questions currently remain to be answered. One of these questions is: Where is

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the process of transition leading? There has been an implicit (and often explicit) assumption that the process of economic transformation initiated by the Chinese Communist Party's (CCP's) formal abandonment of central planning will ultimately lead to an economic system based on market incentives. However, market economies are underpinned by complex legal and market institutions. Market economies do not simply arise when direction from the center is removed and prices are freed. Unless a set of institutions which will support a market economy is allowed to evolve in the PRC, the transition process may be arrested prematurely and the benefits expected from a market system may not be realized. If this is the case, rather than "How long will the process of transition take?" the appropriate question is: Transformation to what?

While institutions can be transformed or replaced, they are not static entities. Each individual institution responds to the changing set of institutions which define the wider economy. Hence, even if the major institutions which currently underpin modern market economies could be instantaneously created in the PRC, there is no assurance that they will work as envisioned or that they will collectively evolve into a set of institutions which operationally mirror those in modern market economies. It seems clear that to obtain a fuller understanding of the economic transition process, a theory of institutional change is required.

This article develops a simple model of institutional change and then attempts to provide some insights into answering the question: Transformation to what? In the case of the PRC, the answer does not appear to be a market economy. Furthermore, it does not appear to be the vaguely defined but officially touted "socialist market economy."

### **Institutional Change and Economic Transformation in the PRC**

Economics has been described as "the science of human choice."<sup>1</sup> Viewing economics as the study of choice implies that the economic approach can be used to examine much more than consumer preferences and production functions of firms—the basis of neoclassical economics. Economic systems

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<sup>1</sup>Ronald H. Coase, *The Firms, the Market, and the Law* (Chicago: The University of Chicago Press, 1988), 4.

are founded on institutional structures which are comprised of firms (producers of goods or services), markets, and a set of legal rules and regulations which govern exchanges between economic agents. Institutional structures can change, however, and since politico-economic systems are founded on these institutions, they can also change.

Each economic system is governed by the institutional arrangements which are the laws and regulations that define property rights in society.<sup>2</sup> Furthermore, these arrangements establish the rules under which individuals compete and interact. In most modern market economies, the rules of the game are established by a constitution. If the rules of the game are not clear and/or are not enforceable, then opportunities exist to take advantage of the situation. One of the problems with the constitution of the PRC is that, in the words of Steven Cheung, "rather than establishing a structure of rights for social and economic interaction, [it] merely serves to confuse."<sup>3</sup> This constitutional void allows government officials (including the managers of state enterprises) who operate within an existing set of rather vague constraints to advance their own self-interest—the "economy of officialdom."<sup>4</sup> It also allows entrepreneurs who operate outside the law to do so with virtual impunity.

According to Cheung, the postulate of constrained maximization asserts as a "universal truth that each individual will constantly seek to benefit himself as much as possible subject to the constraints he faces."<sup>5</sup> Cheung also assumes that Pareto optimality applies to politico-economic institutions—i.e., communism, socialism, and capitalism. Combining constrained maximization with Pareto optimality yields an equilibrium condition whereby: "If constraints permit, people will not interact to harm themselves; if they can accomplish something of benefit at sufficiently low cost, they will work toward that end. It follows that when the constraints or limitations facing them change, individuals will make adjustments until no further improvements are possible."<sup>6</sup> This equilibrium has two key elements. First, the limitations imposed by the constraints determine citizens' ability to maximize their benefits. Second, individuals will act in their own self-interest. We will examine each of

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<sup>2</sup>Steven N. S. Cheung, *Will China Go Capitalist?* (London: Institute of Economic Affairs, 1982), 32.

<sup>3</sup>*Ibid.*, 25.

<sup>4</sup>Ricky Tung, "The Depletion of State Assets in Mainland China," *Issues & Studies* 32, no. 1 (January 1996): 5.

<sup>5</sup>Cheung, *Will China Go Capitalist?* 30.

<sup>6</sup>*Ibid.*

these elements more closely below. However, it is sufficient to state that we have an equilibrium from which agents can move.

Maximization is constrained by transaction costs. There are two broad categories of transaction costs:

1. Execution costs (ECs)—costs incurred in the operation of an institutional arrangement. These include information, negotiation, monitoring, and enforcement costs. Firms and individuals face costs in the search for information about products, prices, inputs, and buyers or sellers. Negotiation costs arise from the physical act of the transaction, such as negotiating and writing contracts (costs in terms of managerial expertise, the hiring of lawyers, etc.) or paying for the services of an intermediary in the transaction (such as broker or an auctioneer). Monitoring and enforcement costs arise after an exchange has been negotiated. This may involve monitoring the quality of goods from a supplier or monitoring the behavior of a supplier or buyer to ensure that all the pre-agreed terms of the transaction are met. Also included are the costs of legally enforcing a broken contract should the need arise.<sup>7</sup>

2. Modification costs (MCs)—those incurred in adapting or changing institutions. These include the costs of acquiring information on alternatives and the costs of inducing change. Execution costs refer to costs which result from using current institutional arrangements, while modification costs refer to costs which must be borne to change any institutional arrangements. It is the combined incidence of these two transaction costs that determine economic institutions. In the absence of MCs, society will always choose an institutional arrangement which reduces ECs. If ECs are lowered, then by definition we can assume that society is better-off. This process becomes the driving force for institutional change. Execution costs can be reduced in two ways: (1) by promoting economic competition with fixed institutional arrangements, and (2) lowering the costs of adopting alternative institutions.

When MCs are positive, those who would benefit from change must assess the stream of benefits which are likely to arise from the lowering of ECs against the MCs which must be incurred to bring about change. If the MCs are high—i.e., if the information costs regarding alternative systems and the costs of negotiating or forcing change are large—then institutional choices will be fewer and ECs may be high. High ECs reduce the welfare of society by reducing overall economic efficiency and inhibiting economic growth over the long run.

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<sup>7</sup> See Jill E. Hobbs, "A Transaction Cost Approach to Supply Chain Management," *Supply Chain Management* 1, no. 2 (1996): 15-27.

The crucial question becomes: What determines the level of MCs? This will be dealt with in detail below. It should, however, be clear that when MCs exceed the benefits expected to arise from lowering ECs, an equilibrium institutional arrangement will be reached. Execution costs will be lowest under a system of well-defined, transferable, and enforced private property rights because, in Cheung's words, "private property rights are unique in that (a) they permit the largest range of institutional choice and (b) competition to reduce transaction costs is enforced by the right to transfer or sell."<sup>8</sup>

When one thinks of private property rights, the material things we own often come to mind—one's house, car, or business. In today's liberal democracies, one forgets that the right to work (or not to work) is a valuable property right. Armed with this property right, one can make investments in skills which will allow one to get a better job with a higher salary. Similarly, employers have the right to hire the workers they believe will be the most productive for a particular position. If a worker is no longer deemed to be sufficiently productive, they can fire that person. Certainly these ideas are not new and are generally accepted in liberal democracies. However, if one takes away the ability to contract one's own labor, the major means of accumulating wealth is removed.

In the strict communist regime which preceded the recent reforms, workers in the PRC did not have property rights, and employment was allocated by the state. Workers were told where and at what rate—usually low—they would be paid. While there has been some loosening of labor markets in the PRC, for the most part the state still exercises considerable control. This is particularly true in state enterprises. Given that individual state enterprises no longer take their direction from the center,<sup>9</sup> in effect this gives the managers of state enterprises control over property rights to labor—and the right to extract the rents from these property rights. This has allowed the managers of state enterprises to greatly enrich themselves. In the absence of effective control from the center, other examples of seeking rents through controlling property rights to labor have arisen; for instance, high-profile examples of prison labor being used for commercial production come to mind. The commercial enterprises of the People's Liberation Army (PLA) which use military labor and enrich local army commanders are another example.<sup>10</sup>

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<sup>8</sup>Cheung, *Will China Go Capitalist?* 41.

<sup>9</sup>See Zhong Zhu Ding, "Mainland China's New Dilemma: Decentralization and Central-Local Conflicts in Economic Management," *Issues & Studies* 31, no. 9 (September 1995): 19-36.

<sup>10</sup>See Stacey Solomon, "The PLA's Commercial Activities in the Economy: Effects and Consequences," *Issues & Studies* 31, no. 3 (March 1995): 20-43.

In societies where individual choice is not allowed—where property rights are not held by individuals—activities must be planned. In planned economies, enterprises are not allowed to sell goods at prices they would have chosen, nor can they decide where to sell or even who to hire. If governments could allocate all resources so as to maximize everyone's preferences subject to resource constraints, then ECs would be zero. However, the information costs associated with national-level planning are enormous.

It is generally recognized that high information costs prevent state planners from being able to effectively allocate resources to provide for sustained increases in economic growth. This led to the ever-widening gap between the living standards in Western economies and those in Central and Eastern Europe and the Soviet Union. It also led to economic stagnation in the PRC. The contrast between the dynamic economic performance of the Republic of China (ROC) as well as Japan, South Korea, and Hong Kong could not be ignored by communist political leaders. Central planning, both in the PRC and other communist states, had simply created ECs which were too high. Well-defined private property rights, on the other hand, lead to low ECs. Property rights induce the development of markets and competitive forces which seek institutional arrangements and minimize ECs.<sup>11</sup> It is the case that "any productive resource is a private property; if within well-defined limits, its owner has: (a) the right to exclude others so that he alone may decide on its use; (b) the right to extract exclusive income from its use; and (c) the right to transfer or sell the property or resource to anyone he sees fit."<sup>12</sup> Having these rights, however, is not sufficient. What goes unsaid is that these rights must be enforced. If enforced, these clearly-defined rights allow individuals in society to accumulate wealth. The basic premise is that if one owns something of value, one should be able to extract the value by selling it or using it to produce value for oneself. Implicit in the system of property rights is the right to make choices. Furthermore, property rights act to restrain competition among individuals who want more of the same economic good—it removes the common property problem of over-use of resources. The ownership of property rights along with the right to choose defines society's winners and losers. If one chooses to use the assets over which one has property rights correctly, one will be a winner. Bad choices create losers.

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<sup>11</sup>Milton Freedman and Rose Freedman, *Free to Choose* (London: Secker and Warburg, 1980), chap. 1.

<sup>12</sup>Cheung, *Will China Go Capitalist?* 32.

If property rights define winners and losers in a society, what determines the distribution of those rights? In a centralized regime dominated by a communist party, the winners and losers are determined by their place in the hierarchy, which the communist party controls. The rents arising from the party's control of virtually all of the property rights in society are distributed to members of the hierarchy primarily to purchase loyalty to those at the top of the hierarchy. Of course, the high ECs mean that the total rents available are much smaller than in market economies.

The reforms initiated by the CCP were aimed primarily at lowering ECs. By reducing control from the center, it was hoped that a movement to an efficient resource allocation system based on markets would arise. The CCP, however, would not consider the co-requisite of well-defined and enforced private property rights. This has led to the evolution of institutional arrangements which allow government officials to act as independent monopolists over the goods or government services they control. The sellers of complementary goods such as permits and licenses each individually attempt to maximize their own revenues independently. The buyer consequently must pay multiple bribes and may have to pay for the same service more than once.<sup>13</sup>

The shift in policy meant that economic decisionmaking is no longer monopolized at the center but decentralized. This shift in policy has loosened the center's control and allowed party officials and bureaucrats to go into the business they knew best, namely "trafficking in influence."<sup>14</sup> It has also led observers of China to conclude that the government is weak and corrupt rather than strong and zealous. While the "reformed" PRC is often perceived as a country of prosperity and growth, it is possible that future growth may be stifled by the corruption associated with the existing institutional arrangements.

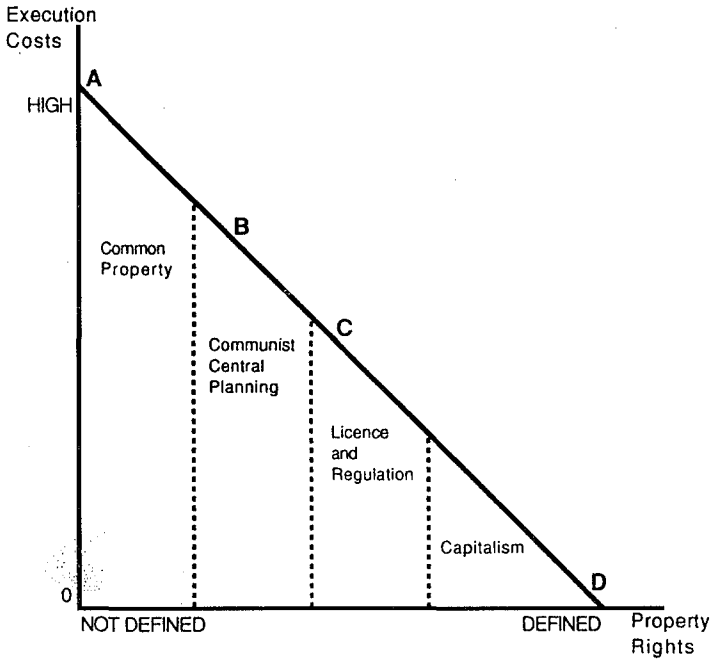
Large-scale personal extraction of rent is now taking place in the PRC, and has often been documented in the frustration expressed by foreign firms which attempt to invest in the PRC. In particular, there has been frustration not so much with paying bribes, but with not receiving the government services that the bribes have paid for. No sooner than one set of officials have extracted their rents than a new group of officials appear with an additional set of licenses and permits which are required. With property rights poorly defined, rents can be captured by those who control the right to transact, whether

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<sup>13</sup>Andrei Schliefer and Robert W. Vishney, "Corruption," *Quarterly Journal of Economics* 18 (1993): 599-617.

<sup>14</sup>*The Economist*, March 18, 1995, 6.

Figure 1



they are in the form of the low wages at which workers in large state enterprises are forced to sell their labor, the bribes which must be paid to expedite imports, or the license fees which accompany permission to undertake almost any production activity. It supports large state monopoly enterprises, fosters rent extraction by privileged officials, and keeps income in the hands of those in command instead of entrepreneurs and workers.<sup>15</sup> The extraction of these rents represents very high ECs for both domestic and foreign businesses in the PRC.

This informal discussion of alternative institutional arrangements suggests that there may be a relationship between ECs and the degree to which private property rights are defined and enforced. Figure 1 presents a stylized representation of four scenarios which lie along a continuum of possible institutional arrangements, and which can be summarized as follows:

1. *Point A*—property rights are common, and as a result, all rents will be competed away. This may be the case in some less developed countries. The

<sup>15</sup>Steven N. S. Cheung, "Privatization vs. Special Interest: The Experience of China's Economic Reforms," *CATO Journal* 8, no. 3 (1989): 585-96.



nomadic cultures of the Sahel, where there has been large-scale degradation of land resources, comes to mind. Other nomadic cultures in East and Southern Africa may have similar common property problems.<sup>16</sup> Of course, high-sea fishing in the absence of effective international regulation is the best-known example of rent dissipation where property rights are not defined. As no one has property rights, transactions cannot take place because the costs of negotiating, monitoring, and enforcing them are nearly infinite. Negotiating costs are high because any group attempting to regulate the use, and hence members' share, of the resource would have to renegotiate the arrangement with any potential new member. Without property rights, no one can be excluded from using the resource and new entrants will always be attracted if there are positive rents. Monitoring and enforcement costs are high because, in the absence of enforceable property rights, all members have an incentive to cheat on their allocation and use resources at a higher level.

2. *Point B—the communist state based on central planning and transaction organized on the basis of command.* This is a hierarchical system where rents accrue to those near the top of the hierarchy. There are only very limited private property rights.

The ECs in this system are very high when strict central planning is followed, and are due to the information requirements of the latter and the monitoring costs associated with command. The prohibitive cost of the information required for effective planning prevents efficient allocation of resources.<sup>17</sup> The lack of property rights in labor—leading to an incomplete set of incentive mechanisms and an absence of labor markets—means that the costs of monitoring labor are too high to prevent shirking on a grand scale, which leads to poor productivity levels and low quality products and services.

This set of arrangements has been labeled "monopolistic corruption,"<sup>18</sup> which normally involves a bribe which is taken once and then "divided between all the relevant government bureaucrats, who agree not to demand further bribes from the buyer of the package of government goods, such as permits."<sup>19</sup> When full centralized control is retained, a monopoly on corruption is easy to maintain. Hence, while the information and monitoring costs are

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<sup>16</sup>Margot F. Somerville and William A. Kerr, "The Common Property Dilemma and Alternative Policy Prescriptions for Specially Restricted Users of Sub-Saharan Rangelands," *Quarterly Journal of International Agriculture* 27 (1988): 136-49.

<sup>17</sup>Ludwig Von Mises, *Socialism* (Indianapolis: Liberty Classics, 1981), 103.

<sup>18</sup>See note 13 above.

<sup>19</sup>*Ibid.*, 605.

extremely high in planned economies, the costs associated with corruption are not prohibitive. Examples of states where monopoly corruption is observed include not only communist regimes, but dictatorships like those of Ferdinand Marcos in the Philippines and corrupt monarchies.

3. *Point C—a system where licensing and regulation are endemic.* Rents accrue to those who license and regulate. In the absence of control from the center, corruption can no longer be monopolized and individuals with local monopolies act independently to extract the maximum rent. Overlapping authority means that multiple bribes may have to be paid. In addition, there is an incentive for local party members and bureaucrats to invent new regulations, permits, and licenses. The freeing of some prices from central control reduces information costs relative to comprehensive economic planning; hence, the efficiency of resource allocation improves. The corruption costs, however, rise relative to the monopoly corruption case of point B.

The "corruption problem" is endemic in India, Indonesia, and a host of other developing countries. Some lessons may be gleaned from their experience. Whether or not the institutional arrangements which encourage corruption are the only cause of their failure to develop, it is clear they do not contribute to economic growth. For example, in Africa, according to Richard Sandbrook, the "pervasive corruption as well as political instability and the inability to prevent widespread evasion of laws"<sup>20</sup> are important reasons for Africa's poor record of development.

4. *Point D—a capitalist system.* Property rights are exclusive and well-defined. Rents accrue to the owners.

It would seem clear that the situation in the PRC prior to the program of reforms begun under Deng Xiaoping in the late 1970s is depicted by point B. The reforms initiated by Deng improved property rights and reduced ECs primarily by reducing information costs. Allowing "responsibility contracts" in agriculture and implementing reforms to labor regulations so that some workers sell their labor to the highest bidder have been examples. Furthermore, allowing limited individual entrepreneurship, foreign capitalists, and more autonomy for the managers of state enterprises has further reduced information costs. The result has been high rates of growth; however, corruption costs have risen commensurately. The real question is whether the PRC will continue the reform process toward point D and join the ranks of devel-

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<sup>20</sup>Richard Sandbrook, "The State and Economic Stagnation in Tropical Africa," *World Development* 14 (1986): 319-32.

oped countries. This brings us back to the MCs associated with initiating institutional change.

### **The Costs of Changing Institutions**

There are two major types of modification costs: (1) the costs of gathering information concerning alternative institutional arrangements; and (2) the costs of persuading (or compelling acquiescence from) those members of society whose real income would be reduced by change. The CCP has ensured that both of these costs are very high. The Berlin Wall served as a focal metaphor for how high these costs could be, and still can be, in communist countries. Nevertheless, the tearing down of the wall in 1990 suggests that these costs can be overcome despite the physical barriers which might inhibit change. In the PRC, the physical barriers have been much less formidable than invisible barriers to change such as poor education, propaganda, and a lack of information technology.

The importance of education as a key factor in economic development is primarily related to the increased productivity of better-educated workers, and hence their ability to generate more wealth. A second role for education, however, relates to the reduction of the costs associated with acquiring information. For example, if students are allowed to study abroad, they will observe alternative systems first-hand and return to their own country to promote institutional change. If books with foreign ideas are allowed to be read, an educated population will foster change. In short, the MCs associated with obtaining information on alternative systems are reduced.

Of course, the CCP still has a large number of mechanisms in place to raise the cost of acquiring information. In the past, closing the country was the most obvious method of increasing these costs. There were prohibitions against listening to foreign media broadcasts. When the PRC, desperate for foreign exchange, decided to open the country to large-scale tourism, individual Chinese were strongly "encouraged" not to have any contact with foreigners. Even when foreign investment was accepted as a means of acquiring foreign technology, initial attempts were made to largely restrict it to special economic zones (SEZs) which could be isolated from the rest of the country. Again, the aim was to keep the costs of acquiring information regarding alternative institutional arrangements high.

With the death of Chairman Mao and the subsequent demise of the Gang of Four, students from the PRC were allowed to study abroad. For example,

approximately 5,000 students from the PRC entered the United States in 1979 and 1980. While this was a minute proportion of the Chinese population, they represented a small crack in a previously closed system. Although it is impossible to prove a direct relationship between the availability of information on alternative institutional arrangements and institutional change, the student demonstrations of 1989 support the hypothesis. When students with better information began to promote, and eventually demonstrate in favor of change, the CCP ensured that the costs of "compelling its acquiescence" were sufficiently high to defer continued change.

Restricting students from studying abroad is one small manifestation of the factors which deter change, and hence work to ensure that a country remains at point B in figure 1. The move away from point B toward point C in the PRC occurred because the government, desperate to lower the ECs associated with acquiring Western technical information, relaxed the prohibitions on studying abroad. The events at Tiananmen Square and the subsequent "supervision" of the student movement imposed sufficient costs on those desiring change to forestall any further highly visible agitation. The tactics used to isolate the women attending the nongovernmental organizations (NGO) forum associated with the formal United Nations conference on women's issues in September 1995 represents another manifestation of the CCP's attempts to limit their people's contact with foreigners who have information relating to alternative institutions.

In another example, in the wake of the Tiananmen incident, information from the outside world was fed to China over fax machines. The CCP could find no effective way of blocking this information without shutting down its phone system. The PRC has been going to great lengths to both control access to satellite dishes and negotiate broadcasting content agreements with those who are establishing satellite systems aimed at China. The information-spreading capabilities of the Internet, one suspects, will provide a great challenge for the CCP. Globalization is essential to China's continued economic prosperity; as a result, the CCP is likely to fight a losing battle in trying to keep the costs associated with acquiring alternative information high. As the CCP becomes less effective in controlling access to information regarding alternative systems, one can expect that the party will have to expend greater resources to increase the MCs associated with agitating for change.

Assuming that factions in society have gained the information necessary to want change to occur, they must then incur the costs associated with persuading and/or compelling those who would lose as a result of the change. In countries where those in power are not accountable to the people, agitating

for change can be fatal. The massacre at Tiananmen Square in June 1989 is testament to the fact that costs can be high and the struggle not always successful.

In its attempt to lower the high ECs associated with central planning, the CCP has initiated a movement away from point B in figure 1. To do this, however, requires that those who would lose from this movement need to be compelled to accept change—primarily those in the hierarchy who benefitted from the ability to extract rents in the rigid centrally planned system. While those at the top of the hierarchy could still extract considerable rents due to their direct control of the political system, promoting individual economic initiative will reduce the rents which could be distributed to middle and lower-level party functionaries and bureaucrats. To get them to accept change, an alternative—and more lucrative—form of compensation had to be found. This alternative has been to allow these party functionaries and bureaucrats to individually extract rents from their ability to license and issue permits and to pocket revenues from state enterprises.

As economic activity has increased as ECs have fallen as a result of the abandonment of central planning and the fostering of individual entrepreneurship, the rents available from licensing and issuing permits have increased significantly. With the heavy hand of central oversight removed, the ability of individual managers to enrich themselves from state enterprises has increased. While much has been made of periodic "anti-corruption drives," their true effect has been largely as propaganda for domestic consumption and potential foreign investors.

The rise of corruption brings up the question of those in the CCP who would like to move the PRC back to point B. Returning to the command system seems unlikely, because it would require that hard-line communists induce or compel those who have acquired the power to extract licensing and regulating rents to surrender that power. This is not possible for two reasons: (1) the total amount of rents would be less than in the current decentralized system, and (2) those who would have to give up the power to extract rents would then be subject to the whims of those at the center for their share of the rents.

Is the PRC likely to move from a position such as point C to one such as point D and reap the benefits of the low ECs associated with a full market economy? The licensing and regulation system creates vested interests and it will be very costly to induce change, and this will likely remain the case whether or not the CCP survives as the governing political entity. The communist party no longer governs in Russia and many of the new independent

states of the former Soviet Union, yet former party functionaries remain in place and corruption is endemic.

India is often cited as an example of how corruption impedes development. While India does not have a shortage of highly educated people, this may have actually hindered the process of economic development, as it has been in many's best interests to occupy a public service position where it is possible to extract large rents. Thus, those who might be expected to advocate alternative institutions have become part of the problem. The MCs associated with altering this form of institutional arrangement may be extremely high, as it is not sufficient to topple the hierarchy to institute change. As has been seen, African governments often change but corruption continues unabated. The end point of transition may be economies similar to India or Nigeria rather than the Republic of China or Hong Kong. The latter's major concern is that it may move from point D to point C now that it is under PRC control. Given the weakened control exercised from Beijing, even if the CCP is willing to maintain Hong Kong's special status, individual officials are likely to find opportunities for rent extraction through licensing too hard to resist.

### Conclusions

The economic transition currently taking place in the PRC needs to be examined from the broad perspective of institutional change. The PRC is currently in institutional disequilibrium, as the dynamic process instituted by the CCP's economic liberalization process has led to considerable lowering of ECs, and hence economic growth. However, the failure of the CCP to put in place a property rights system which will lead to a minimization of ECs will mean that the full benefits of liberalization will not be realized. While property rights have been expanded since the era of strict central planning, in many areas of the economy, property rights are not well defined. This allows both officials who can license and issue permits and those who run state enterprises to capture the rents which should go to owners of property rights.

Bribes and the nonmarket pricing mechanisms of state enterprises have increased the ECs of entrepreneurs, reducing economic efficiency. Furthermore, "paying the bribe" does not necessarily lead to the delivery of the service, because other officials may also be able to extract bribes for the same service, making investment riskier than it need be. This means that investors require higher rates of return and the quantity of investment will be suboptimal, negatively affecting economic growth and international competitiveness.

The opportunities arising from reducing the ECs associated with central planning have been very large; hence, economic growth in the PRC has been strong in the wake of liberalization. However, as the institutional arrangements which support a licensing and regulation economy become well entrenched, a new equilibrium such as point C in figure 1 may be reached. Given the large MCs associated with inducing those who benefit from this type of institutional arrangement to give up their rent-extracting privileges, any movement to point D is likely to be choked off.

Those with the ability to license and sell permits will resist any further extension of private property rights because this will reduce their rents, while those who manage state enterprises will attempt to limit any improvement to owners' rights or privatization because being responsive to investors will inhibit their ability to extract personal rents. Given that many of those at or close to the center in Beijing are benefitting from the current institutional arrangement, they may not have the will to change it. Even if they did wish to move forward, it is doubtful if they still have the power to enforce a radical extension of private property rights.

Still, a powerful force for change also exists. The information revolution continues to lower the MCs associated with acquiring information on alternative systems. In the coastal regions, contacts with international business people and the wider world have led to a more rapid expansion of property rights than in the interior—leading to disproportional economic activity and wealth. This strong economic performance has led to calls for greater regional autonomy which further weakens Beijing's control. This may lead to a variety of systems evolving over the range of the licensing and regulation segment of figure 1.

Is mainland China evolving into a market economy? The evidence suggests that the transition process from central planning may reach an equilibrium which is far short of a market economy. If this licensing and regulation equilibrium does come to pass, long-run prospects for economic development may be thwarted.