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On Deep-Rooted Problems in China's Economy

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Abstract China's economy is currently at a crossroad leading to two different directions. One is to further deepen the reform, concentrate on crucial aspects and relax control over details, govern by non-intervention and let the market play an increasing role and lead the economy; while the other is to enhance the state sector with weakening the private sector, and let the government play a greater role and lead the economy. Which direction should China head for? The answer would undoubtedly be the former. As such, this paper argues that there does not exist the so-called "China Model" and attributes the deep-seated problems caused by those misconceptions in China's economy to three pairs of "over-emphasis" versus "under-emphasis", namely, over-emphasis on the government versus under-emphasis on the market, over-emphasis on enriching state versus under-emphasis on enriching the people, and over-emphasis on development versus under-emphasis on public service. Moreover, in regard to how to solve these problems, the paper proposes to further advance the two fundamental transformations of government functions: (1) to transform from a development-oriented government to a service-oriented government, and (2) to transform from an omnipotent government to a limited government.

Keywords government versus market, enriching state versus enriching the people, development versus public service, government functions

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1 Introduction

Once again China has reached a crossroad in its economic reform—to further

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deepen the reform along the direction of letting market play a really prominent role by limiting the government role to the most crucial aspects of the economy only, preventing it from intervening in a too detailed way, or to move along the direction of further expanding the state sector by reducing the private sector and letting the government play a more dominant and greater role in economy?

Undoubtedly, China has remarkably followed a market-oriented economic transition path that suits its own resource endowments under its current political, economic, social and cultural structures rather well. Although other Asian countries and regions have also experienced similar continuous and rapid growth during the period 1960s to 1980s, for a nation like China with a population of more than one billion, it is an unprecedented achievement in maintaining an average growth rate close to 10% for 32 years and get about 0.25 billion people out of poverty. In the meantime, China's economic system has also undergone a smooth transformation from a planned economy to a market-oriented economy. Now the gross industrial output of non-state-owned economy accounts for more than 80% of the entire economy in contrast to 8.78% at the early stage of economic reform, and it has become the driving force for the economic growth of China. With gradual transition and leapfrog development for over 30 years, many aggregate economic indicators of China have already risen to the top rank in the world. For instance, China is now the second largest economy in the world and thus becomes a significant force in the global political and economic arena.

However in this context, there emerge some arguments that attribute the success of China's reform to a government-led economic development route, social management mode and political governance structure. It is believed that an ultimate development mode, or the so-called "China Model", that is stable, mature, widely applicable and different from that of modern societies, has been found. This attitude may be a type of fatal arrogance that virtually mistakes a "sub-optimal" for "the optimal" by viewing a transitional institutional arrangement as an ultimate one.

This paper first analyzes that there does not exist the so-called "China Model" and the internal logic China's successful economic reform complies with is of no particularity, but China has established an economic development route with Chinese characteristics. It then attributes various deep-seated problems in China's economy to three pairs of "over-emphasis" versus "under-emphasis", namely, over-emphasis on the government role versus under-emphasis on the market, over-emphasis on enriching state versus under-emphasis on enriching the people, and over-emphasis on development versus under-emphasis on public service. To solve these problems, China must implement the two fundamental transformations of government functions: (1) to transform from a development-oriented government to a service-oriented government, and (2) to

transform from an omnipotent government to a limited government.

The remainder of the paper is organized as follows: Section 2 analyzes why there does not exist the “China Model”, Section 3 discusses the deep-rooted problems in China's economy, and Section 4 explores the key to the next stage of reform in China.

2 Does the So-Called “China Model” Exist?

The answer is that there does not exist the so-called “China Model”, but only “China Path” or “China Experience” by the following reasoning.

First, if we take the “market economy, law-governed society and democratic politics” as the goal of transition and development, and the universally acknowledged modern elements like freedom, rule of law, democracy, justice and welfare as the measurement indicators, the so-called “China Model” is far from achieving the goal and meeting the standards, which is still in the process of shaping and optimizing, rather than a mature and ultimate model. China still has a long way to go to become a modern and powerful country and to achieve the modern social development goal in the real sense.

Second, from the perspective of transition and development process, no late-developing countries can completely copy the development experience of early-developing countries because of the differences in initial endowments, endogenous conditions and external constraints. Therefore, it is both necessary and imperative for the late-developing countries to figure out their own ways for development. Due to the extreme distortion of planned economy in the initial stage of China's economic transition, government has played an important role in realizing the efficiency, fairness and harmonious development of social economy. However, once the government goes beyond its reasonable management scope to excessively and continually intervene in the affairs that should be handled by society and market, there will be serious consequences. In other words, the uniqueness of developing path of a country does not indicate that the direction of the path should deviate from the ultimate goal of having a limited government and an effective market for a modern society.

Third, the great achievements in China's economic development can be essentially attributed to the following aspects: recognizing individual interests, offering economic freedom, encouraging people to create wealth, introducing competition mechanism (including the competition between state-owned enterprises and private enterprises and the competition between local governments), as well as carrying out opening up policy. These efforts to “set things right” in the economic field reflect the internal logic of economics. The above reasons are also the common experience that has been repeatedly verified by some East Asian, or even Western countries. Besides, properly handling the

relationship between development and stability and adopting the gradual transition mode suitable for China have also contributed to the great achievements in China's economic reform.

Through further analysis, it is found that misconceptions in the following three aspects may have led to the so-called "China Model" argument.

First of all, it does not make a clear distinction between different stages of development. In fact, the government-led sub-optimal transitional arrangements should be in resemblance with the role parents play in the growth of a child. At the infant stage, it is necessary for the parents to offer guidance and help, but as the children grow up, parents are supposed to gradually step back and let the children grow on their own. Therefore, the parents-led (government-led) pattern is only the characteristics of a certain stage in the growth process of children (development of market economy), rather than a long-term and ultimate model. However, currently the government seems to have a strong tendency towards "paternalism", regarding market as a child that never grows up.

Moreover, it does not well distinguish between common and special circumstances. To deal with the current global economic and financial crisis, governments around the world have all intervened in the operation of market economy with unprecedented efforts. The Chinese government is no exception and has achieved satisfactory outcomes. Therefore, a conclusion has been largely drawn that it is necessary to let the government lead the economic activities, and thus the government's dominance and continuous intervention in the market tend to be reinforced. However, this should have been the particular measure for addressing crisis under special circumstances. In some Western countries with market economy, governments have begun to withdraw; while China, on the other hand, tends to recognize the pattern of government-led economic development as an important experience and normalize it.

Finally, it does not clearly differentiate between the momentum and resistance of development. Due to the enormous energy and momentum generated by market-oriented reform and opening up just like a rising rocket, the positive impacts far exceed the negative impacts of various problems in the transition process despite the existence of huge internal and external resistance and friction, including those negative impacts brought by government-led economic development and social governance. As a result, some unknowledgeable and short-sighted people take resistance wrongly as driving force, mistake disadvantages for advantages, and frequently confuse major issues with minor issues, thus giving rise to specious arguments that are common.

3 What are Deep-Rooted Problems in China's Economy?

Based on our observations, those long-term and deep-seated fundamental issues

facing China's economy lie in the three aspects: the remaining deep-rooted institutional barriers, the lagging deep market-oriented reform, and the irrationally defined governance boundary among government, society and market, which has led to an unscientific outlook on development featuring three pairs of "over-emphasis" versus "under-emphasis", namely, **over-emphasis on the government versus under-emphasis on the market, over-emphasis on enriching the state versus under-emphasis on enriching the people, and over-emphasis on development versus under-emphasis on public service.** They are briefly explained as follows:

In the first place, with over-emphasis on the government versus under-emphasis on the market, deep reform is lagging behind. The remarkable achievements in China's economy over the past 30 years are closely associated with the fact that the degree of marketization has significantly increased thanks to the development of non-state-owned economy through market-oriented reform and the exit of government from where it should not step in. However, in the dynamic process of market-oriented reform, the "big government and small market" pattern remains unchanged fundamentally. Some scholars even regard the government-led rather than market-oriented mode as the essence of the so-called "China Model" so that government intervention is either excessive or inadequate in different fields, leading to more and more over-playing, mis-playing and under-playing of government role. With too much control on factors of production, important resources and market access, government enhances its role from market order maintainer to market participant, thus restricting the private economy and entrepreneurship to a large extent. Moreover, due to the severe institutional obstacles of government-led pattern, there is limited room for the survival and development of private economy and its role as driving force is weakened, which has also led to the stubborn corruption behaviors of private enterprises bribing public power owners with private interests despite repeated prohibitions.

Many of the deep-seated puzzles and problems in China are related to the over-playing, mis-playing and under-playing of government role, such as government's competing for benefits with its people, increasing administrative intervention, unreasonable economic structure, deteriorating income distribution, imbalanced economic structure, relatively weak consumption drive, unequal opportunities, ecological destruction, environmental pollution, continuously widening urban-rural and wealth gap, increasing corruption and violation of laws and regulations, growing influence of interest groups, as well as social credit crisis, severely insufficient input in education, weak national basic education, dramatically increasing criminal cases, economic disputes and civil disputes, expanding trend of unstable social structure and declining sense of happiness of the people, etc.

With diversified subjects of social interests, complex interest contradictions and acute interest conflicts, the reform has already gone beyond the Pareto improvement stage that is beneficial to all, and its further deepening will inevitably offend some vested interest groups, including government with its own large interests obtained by high intervention in the economy. As a result, the drive for reform is weakening and the consensus on reform is diminishing. Many people dwell on the past success of reform and hold still to the previous development experience, not knowing that past success under the lead of government does not necessarily ensure future success and the government-led development experience may also become a shackle for future development. In this context, to ensure further progress of reform, the administrative system reform and the corresponding political system reform of government are even more necessary.

In the second place, with over-emphasis on enriching the state versus under-emphasis on enriching the people, the role of market has not been brought into full play. Government's competing for benefits with its people is mainly reflected in the following two aspects. First, the tax revenue growth of government remains high. Since the 1990s, China has maintained an annual income growth rate of urban and rural residents within 10%, while the average annual growth rate of government financial revenue is close to 20% over the same period. More significantly, recent years have witnessed an apparent trend of widening disparity between them. The fact that individual income tax threshold remains too low while the tax rates stay too high shows a sharp contrast to the U.S.'s exemption of individual tax in its early stage of development. Not until 1913 when the U.S. became the most developed country in the world did it begin to levy personal income tax through the passing of a special constitutional amendment. Secondly, government is excessively development-oriented. Government still holds a dominant place in many fields where market is supposed to play the role of resource allocation and becomes the main body for monopoly profits, thus squeezing the market incentive revenue opportunities for residents. For example, government demands land acquisition on farmers with low-cost and then resells the land by commercial means of auction, which is a very common form of huge land finance of local governments, pushing housing price to an unusual high level; state-owned enterprises in the monopoly industry live well on monopoly profits, but in the event of deficit they impose the loss upon the whole people; government may also enforce price control on key elements and make them deliberately low, thus leading to a severe distortion of the three basic roles of market price in conveying information, providing incentives and determining income distribution.

The fact that national income distribution is excessively tilted to government leads to two consequences. First, domestic consumption of China remains at a

low level, and it can only rely on investment and export for economic growth. China’s final consumption rate in 2009 was only 48%, lower than that of not only the developed countries (such as the rate of over 80% for the U.S.), but also other emerging economies (such as 80.9% for Brazil, 63.7% for Russia and 67.1% for India in 2008). Even dating back to the same development stage of major developed countries, China’s consumption rate is still relatively low (see Fig. 1). Secondly, various social, economic and government-people incompatibilities associated with institutional conflicts of interest have become the primary direct source of more and more social group conflicts, starting to affect social stability.

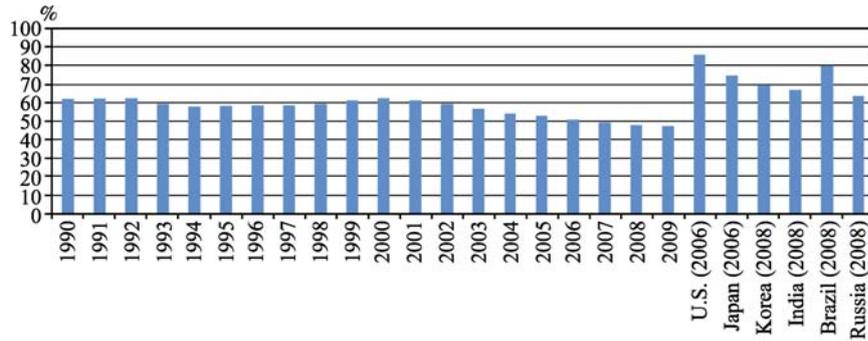


Fig. 1 Final Consumption Rates below Global Level (Percentage of final consumption in GDP)

Data source: World Bank WDI Database.

Table 1 Changes in Final Consumption Rates of Major Developed Countries with Per Capita GDP at USD 3000 and USD 10000

Country	Per Capita GDP Reaching USD 3000		Per Capita GDP Reaching USD 10000	
	Year	Final Consumption Rate (%)	Year	Final Consumption Rate (%)
United States	1962	78.6	1978	78.7
Japan	1973	61.9	1984	69.1
Germany	1971	74.8	1979	80.2
France	1971	73.7	1979	76.5
Britain	1973	79.8	1986	82.7

Data source: Zhao (2010).

China’s early reform practice of “allowing some people and some regions to get rich first” tells us that despite any other crucial issue, big or small, the utmost significant one is to give people more freedom of choice. Reform practice from rural to urban areas shows that wherever there are looser policies and a greater degree of economic freedom, there would normally be higher economic

efficiency and more well-being for people. In this sense, to solve the current problem of a wealthy nation with poor nationals for China, the fundamental way is to reduce tax, give wealth back to people and at the same time further intensify deep market-oriented reform. Some scholars regard the focus change from a wealthy nation to wealthy nationals as the highlight of the 5th Plenary Session of the 17th Central Committee of the Communist Party of China. This is an exciting change we are all looking forward to. Yet if the internal logic for enriching the people is not made clear, it will be difficult to effectively bridge the gap of national income distribution, which will then impair the two basic constraints of participation and incentive compatibility that should be satisfied by an effective institutional arrangement, thus affecting social harmony and stability as well as sustainable economic development. From the perspective of property right, the internal logic for enriching the people should be “to enrich the people, private rights need to be assigned, and to protect private rights, public power needs to be limited”, the key to which can be boiled down to a reasonable definition of governance boundary between government and market and a full play of market role.

In the third place, with over-emphasis on development versus under-emphasis on public service, the positioning of government is not accurate. This problem is closely related and interconnected to the first two problems. As mentioned before, with the long-term tendency of over-emphasis on government and enriching the state versus under-emphasis on market and enriching the people in China, government has been holding a dominant place in resource allocation and used its resources mainly for economic development rather than public service, thus gradually forming a “development-oriented government in competition for benefits with its people” model: on one hand, government over-plays its role and acts as the principal agent for economic development and investment, squeezing the room for residents to acquire incentive income from market; on the other hand, government should have utilized the high tax collected from the incentive income of residents to enhance public welfare, but in fact it has ignored social security, health care, education, environment and other public service infrastructure construction, thus rendering the welfare benefits of residents insecure.

Although China’s expenditure on education, poverty alleviation, social security and health care has increased in recent years, its proportion in the total fiscal expenditure is still very small. For instance, in the year 2009, 1,043.754 billion yuan was spent on education, 760.668 billion yuan on social security and employment, 399.419 billion yuan on health care and 193.404 billion yuan on environmental protection, the sum of which accounted for only about 30% of the total national fiscal expenditure of 7,629.993 billion yuan in that year, while the corresponding proportion for the United States over the same period was more

than 50%. Practice also shows that the imbalances between economic and social development, urban and rural development, regional development as well as economic development and ecological environment are all associated with this government-led model and the under-playing, mis-playing and over-playing of government role.

The imbalance between urban and rural development is becoming increasingly exacerbated as is shown in the enlarged income disparity between urban and rural residents despite an overall steady income growth (see Fig. 2). Income ratio between urban and rural residents has jumped from 2.57 in 1978 to 3.33 in 2009 (though it has once declined to 1.82 in 1983). In 2008, the Gini coefficient of China reached 0.47, which has surpassed the internationally recognized warning line of 0.4. In this sense, enriching the people has two connotations: first, to enhance the overall income level of residents; second, to achieve a relatively reasonable structure of income distribution.

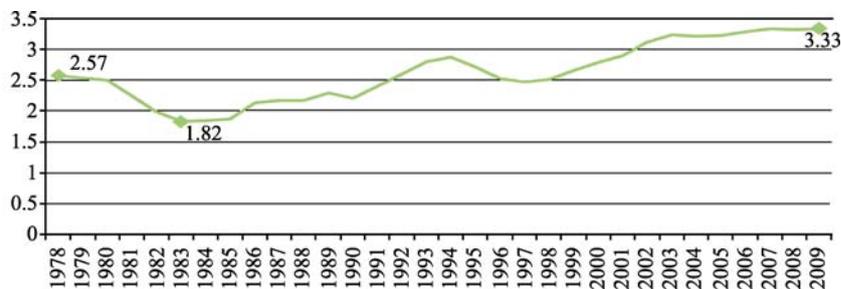


Fig. 2 Unoptimistic Change Trend of Urban and Rural Income Ratio

Data source: Statistics Database of China Economic Information Network.

If economic issues over income distribution have not been duly emphasized, they may transform to deep-seated social problems at any time. Obviously, with the absence of the above-mentioned social public infrastructure development and a relatively reasonable social wealth distribution system, it is difficult to guarantee the conditions for a fair starting point for citizens to participate in market competition. Thus, social fairness and justice will not be achieved. Rawls once wrote: "Justice is the first virtue of social institutions, as truth is of systems of thought". Premier Wen Jiabao also said at the Press Conference of the 3rd Session of the 11th National People's Congress in 2010 that, "Fairness and justice shine even brighter than the sun". For China at the present stage, to achieve inclusive growth with both efficiency and equity, the key is to make significant changes in the positioning of government.

The core of the above three deep-rooted problems is that the boundary between government and market has not been properly defined. An essential

reason is that the Keynesian theory, framework and tools have been excessively applied in China's macroeconomic governance. The Keynesian government intervention theory can only serve as a stimulating stop-gap measure with temporal and superficial effects, rather than comprehensive treatment based on systematic thinking and general equilibrium approach. Besides, too much application of the theory will also bring a lot of side effects. For instance, under the powerful macro-control of government that sways between conducive and obstructive effects, China's real estate market faces a severe distortion of the three basic functions of market in conveying information, providing incentives and determining income distribution. Many human factors and much administrative intervention have made the phenomena of information asymmetry, incentive incompatibility and income inequality particularly evident in this industry.

To establish a real market economy and achieve long-term stability, China should not rely on the Keynesian theory, but the profound economic thought of Adam Smith, J. A. Schumpeter, F. A. Hayek, Ronald Coase, Leo Hurwicz and some other economists of the free-market school who demonstrate the optimality of market from different perspectives. For instance, Smith (1776) proved the optimality of market from the perspective of the division of labor in society and efficient allocation of resources. Schumpeter (1934) demonstrated from a dynamic perspective that it is market rather than government that can best arouse innovation and entrepreneurship, which are the core incentives for the sustainable economic development. Coase (1960) illustrated the optimality of market in view of the importance of clearly defined property rights. Hayek (1945) demonstrated the superiority of market system to planned economy system from the viewpoint of information and incentive. Debru and Scarf (1963) showed by proving the concept of economic core first studied by Edgeworth (1881) that under very general technical conditions, even with no prior institutional arrangements, once individuals have the basic private rights and are allowed to fully compete, voluntarily cooperate and voluntarily exchange, the resulting outcome is the same as competitive market outcome, thus achieving the efficient allocation of resources and the naturality and objectivity of market system. Hurwicz further proved the uniqueness and effectiveness of market mechanism in terms of informational efficiency and allocative efficiency. As long as everyone or at least someone aims at the maximization of personal interests, then the competitive market mechanism with clearly defined property rights is the only and most informational efficient mechanism that achieves efficient allocation (Hurwicz, 1972, 1973, 1979, 1986; Tian, 2002, 2003).

Thus we can recognize that the core features of market mechanism are the requirements of clearly defined property rights, economic freedom and full competition for individuals, and it is proposed that exchange of resources under

the above three conditions can achieve efficient allocation of resources. Therefore, market mechanism is not a man-made invention, but a natural social choice result with its own internal logic that is the common wealth of mankind. Therefore, comprehensive treatment from the angles of so-called “Tao, Shi and Shu”¹ is required for the Chinese economy. “Tao” refers to the basic principles, objective laws and justice that we must follow, “Shi” means the environment, trend, momentum and advantages, and “Shu” indicates the specific ways and methods for implementation. China's economic reform must first of all follow the basic objective laws of modern market economy, which is the fundamental principle. Meanwhile, we should take into consideration the actual situation that we are facing at home and abroad, and be skillful at seizing opportunities by following the fundamental trend. We should also pay attention to the ways and methods in dealing with China's economic growth and development issues.

In tackling these issues, we need to address both symptoms and root causes. If the short-term hot and difficult problems as symptoms in most cases are not properly handled, their deep-rooted causes in the long term may further aggravate; meanwhile, if we ignore the long-term and underlying fundamental problems, it may add to the difficulty of resolving short-term hot and difficult issues. Therefore, one should take a rational look at economic growth in order not to miss the opportunities for deep economic restructuring and development pattern transformation for the sake of securing short-term growth goal. One should identify and resolve the long-term and deep-seated fundamental problems in China's economy when the economy is basically back to normal.

4 The Key to the Next Stage of Reform in China

Based on the above analysis of the long-term, deep-rooted and fundamental problems of the three pairs of “over-emphasis” versus “under-emphasis” in the Chinese economy, one of the basic conclusions in this paper is that China needs to further emancipate the mind, make clear the direction of reform, continue to bear an awareness of crisis and gather consensus on reform and its endogenous motivation to effectively promote deep market-oriented reform in order for a real change in development mode and an economic restructuring. The nature of market lies in non-intervention, and a necessary condition for non-intervention is to improve market system to make it effective; meanwhile, for market effectiveness, a necessary condition is to have an effective government; and for a government to be effective, a necessary condition is to be a limited government with proper positioning.

¹ “Tao, Shi and Shu” are drawn from the essence of Chinese philosophy, especially the philosophical thinking of Lao-Tzu and Sun-Tzu.

Therefore, the key to the next stage of reform in China is the two fundamental transformations of government functions, i.e., the transformation from a development-oriented government competing for benefits with its people to a service-oriented government of public interest and the transformation from an omnipotent government of excessive administrative intervention to a limited government that admits the full play of market, in order to establish the basic rule for the full play of market mechanism to achieve governance by non-intervention and scientific development. They are specifically described as follows:

First, the transformation from a development-oriented government to a service-oriented government. In a modern market economy, the major role of government is to create a favorable economic and social environment for enterprises as the micro-economic subjects in order to provide the necessary software and hardware infrastructure for economic development. This is the economic dimension of government's public service. In addition, government must also play an important role in case of market failure, which is its social public service. It means government should support education, science and technology, social security, public health care, environmental protection and other social development projects through transfer payments and financial means for a fair starting point for all citizens to participate in market competition.

Therefore, government should minimize its role as an "economic man" and expand the scope and intensity of its public service rather than economic development or even benefit-making. This is actually the nature of government. Thus, to comprehensively evaluate the performance of government, we should not rely on GDP indicator only. Social public service indicator should be taken as a hard constraint, which requires the government to extend the "helping hand" more often than "grabbing hand", and let play the "non-intervention hand" for more wealth flow to people to maximize socio-economic welfare. Only in this way can we reform the government performance evaluation system fundamentally and lead local governments to pay more attention to scientific development in order to promote stable and rapid sustainable development and eventually build up a harmonious society.

Second, the transformation from an omnipotent government to a limited government. Government reaches out to every corner of economy and exerts excessive intervention so that "social relations" override rules, which in itself shows that China's marketization is far from mature. An absolute majority of countries in the world adopt market economy, yet only a small proportion of countries have established a real standard market economy. The reason is that they have not built up a legal environment and a democratic system, and are still stuck in the morass of crony capitalism with "rent-setting and rent-seeking". Therefore, the key to the establishment of a limited government is to make the exercise of public power subject to legal binding and public supervision, which is

actually the issue of democracy and rule of law.

In this sense, to achieve breakthroughs in deeper reform and innovations in development, China should further accelerate its political system reform, at least administrative system reform, which should be an important agenda for the next 30 years of reform and opening up and serves as the basic guarantee for the realization of long-term stability and national modernization. However, as political reform is a systematic project, one should avoid being complacent, conservative or unrealistic, and advance step by step for solid progress. An urgent priority for the current stage is to carry out in earnest the administrative system reform as an important part of political system reform. The real criterion for evaluating government performance lies not in the extension of its administration scope, but the reasonableness of its management scope and extent, the effectiveness of its administration methods and results, as well as its role in ensuring effective market and government. According to Lao-Tzu, this means "reigning the country fair and square, using martial forces flexibly, and governing the people with little intervention" (i.e., "to be righteous in deed, flexible in practice and minimal in intervention").

Our practice shows that one important reason for the present social conflicts is the series of deep-rooted problems caused by the almighty government management mode implemented during the planned economy period of China. It is thus imperative for the government to hand over the responsibilities that it should not take to enterprises, social organizations and intermediary agencies, giving fuller play to the basic role of market in resource allocation. Meanwhile, government should perform its duties well and improve its administration efficacy and work efficiency. Therefore, in the process of building up a harmonious society, government should accelerate the transformation of its management mode from an omnipotent government to a limited and effective government, and shift its primary role from micro management to macro management and from direct management to supervision, thus laying a solid and reliable foundation for economic system restructuring, social system reform and a higher-level political system reform.

In summary, the purpose of the two fundamental transformations of government functions is to rationalize the definition of governance boundary among government, society and market, thus eradicating the problem of over-playing, mis-playing and under-playing of government role and giving full play to market mechanism. Specifically speaking, only when the ten basic dialectical relations between "government and market, prosperous nation and wealthy people, efficiency and equality, investment and consumption, domestic demand and overseas demand, rural areas and urban areas, coastland areas and inland areas, development and stability, development and education, development and ecology" are properly handled and the deep reform and

long-effect system establishment are strengthened can we truly realize governance by non-intervention on the basis of reasonable and sound rules under market economy to promote scientific development, build a harmonious society eventually and thus achieve long-term sustainable development.

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