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On the Fundamentals of a Successful Reform for National Prosperity—An Economic Analysis Based on the Practice of China's Reform

Abstract This paper discusses the fundamentals required for successful reform, i.e., the necessary institutional changes required to make a nation grow sustainably wealthier. It argues that enriching the people is a prerequisite for a prosperous nation and further reveals the inherent logic behind the statement “in order to enrich the people, they must be given private rights, and in order to protect the people’s private rights, public power must be limited.” Based on this argument, we examine and analyze the experience of China’s reform over the past 30 years and come to the conclusion that it is necessary to transform government functions and further deepen market-oriented reform. We hold that China’s economic performance bears no special or exceptional economic law, and there does not exist the so-called “China Model” characterized by government taking the leading role as a relatively mature, stable, and widely applicable development model, but that there does exist a Chinese development path or experience featuring the inherent logic of “prospering the nation through enriching its people” that can be employed by countries all over the world.

Keywords prospering the nation through enriching its people, information asymmetry, incentive compatibility, limited government

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1 Introduction

China's experiment with reform and opening up since 1978 has placed itself onto a path of strength and prosperity, ushering in the most glorious chapter in China's history. Now the Chinese economy has become a crucial and major force in the world economy and a basic market economy framework has already taken shape. Along with this, however, due to an absence of a timely adjustment in the distribution of national wealth, there exists an increasingly exacerbated phenomenon whereby the government competes with the people for profit and the nation grows wealthier while its people remain disadvantaged. This phenomenon poses a grave obstacle to China's continued sustainable economic development (Tian, 2010a). More significantly, recent years have witnessed an apparent trend of the widening disparity between government financial revenue and household income growth. The fact that the individual income tax threshold remains too low while the tax rates stay too high shows a sharp contrast to the USA's exemption of individual tax in its early stage of development.¹ Additionally, in the pretext of enriching the nation, state-owned enterprises have been reduced to sectorial monopolistic interest groups that impose their losses upon the people. As a consequence, large pockets of national wealth concentrates in the hands of the government and large state-owned enterprises, rendering the public unable to fully share the significant assets and revenues from economic reform. This is also the fundamental cause of the prolonged inadequate release of household consumption. Furthermore, these conflicting institutional interests have become the primary and direct source of social unrest and group conflict, disturbing social stability.

To overcome the dilemma between economic development and wealth distribution, "enriching the people" is a desirable developmental goal of China. The next question is: how to enrich the people and what is the relationship between enriching the people, prospering the nation, and strengthening the nation? This policy must be properly targeted and implemented to prevent deviation from its aim, which could then possibly result in the impoverishment and weakening of the nation instead. A correct response to this question requires a reasonable interpretation and reflection upon China's reform experience over the past 30 years. Domestic scholars have presented their thoughts on having people enriched as both the foundation and top priority, from a comparative perspective at the vertical, historical and the horizontal, global angle (Ding, 2010; Wang, 2010a, 2010b). Yet little literature argues from the inherent logic of economics or outlines any systematic means to enrich the people. An absence of theoretical analysis or guidelines on a systematic basis would possibly give rise to stopgap measures or policies on an ad hoc basis.

¹ Not until 1913 when the USA became one of the most developed countries in the world did it begin to levy personal income tax through a special Amendment to the Constitution.

The remainder of the paper is organized as follows. Section 2 argues the proposition of “enriching the people as a prerequisite for a prosperous nation.” Section 3 expounds the inherent logic in “enriching the people” and illustrates the means to enrich people by discussing the essentiality and efficiency of market mechanisms. Section 4 gives an interpretation of China’s reform practice by analyzing the inherent logic of “enriching the people as a prerequisite for a prosperous nation.” Section 5 makes a conclusion and inquires into the misconception of the “China Model” and China’s future direction of reform.

2 Enriching People as a Prerequisite for a Prosperous Nation: An Economic Analysis

Enriching the people as a prerequisite for a prosperous nation is a well-grounded and well-known concept. Yet when it comes to how to enrich the nation, countries around the world have implemented different strategies and their success has primarily been determined by the handling of the relationship between enriching the people and prospering the nation. The fundamental causes of failure of the three reforms for self-prospering since the mid-19th century in China, namely, the Westernization Movement, the Bourgeois Democratic Revolution and the Planned Economy, all lie in the fact that the target to enrich the people was ignored by only emphasizing the target of empowering the nation through reliance on the state apparatus to create and accumulate wealth. In contrast, only when enriching people is put in the first place and individuals are given opportunities and incentives to seek and create wealth will a nation grow strong and prosperous. This argument can be demonstrated and supported to a varying extent by a number of historical examples: the Rule of Wen and Jing in China’s Han dynasty, the booming and golden age of the Qing dynasty (from Emperors Kangxi to Qianlong), the reform and opening up in the modern era,² and the self-building and self-prospering process of the United States. Therefore, a basic conclusion can be drawn that enriching the people is a prerequisite for prospering a nation, as can be seen from the experience and lessons of China and the rest of the world through their thousands of years of self-building practice;

² The peaceful and prosperous society in Feudal China is not a society where people are enriched in the modern sense, yet viewed from a historical retrospect with a vertical comparison, Feudal China’s policies of relieving people’s living, working and tax burden to have them settle in relief and harmony became a necessary condition for its peaceful and prosperous ruling under which people were relatively enriched. Likewise, China’s significant accomplishment through reform and opening up is also achieved in a relative sense in that enrichment of the people in modern society is far from realized (as a matter of fact, people are poor compared with the government but are much wealthier compared with how they were 30 years ago). Based on the current benchmark of the USA, China undoubtedly has a long way to go.

furthermore, this historical conclusion has a foregone inherent logic in economics.

2.1 The Logical Starting Point of “Enriching the People as a Prerequisite for a Prosperous Nation”: Two Basic Conditions for an Effective Institutional Arrangement

The starting point of the inherent logic in this proposition is that any policy or institutional arrangement is unavoidably subject to two basic objective realities: individual self-interest and information asymmetry. Normally, a subject (individual, enterprise or state) is always seeking the maximization of self-interest,³ this is the most significant objective reality in society at its current development stage and also the most fundamental behavioral hypothesis in economics. Recognizing the self-interested nature of human beings is a realistic and responsible attitude to solving social issues, which is alike with the demand of party disciplines and the laws of the state to prevent opportunists from taking advantage of loopholes in the system and regulations under the hypothesis that humans are altruistic. Conversely, if altruism is taken as the basis to resolve such social and economic issues, catastrophic consequences might occur where people rush to take advantage of loopholes in the system and develop an equalitarian thought of waiting to share collective interests and expecting others to assume the duty of building an ideal communist society. This was the case in the pre-reform times when production was organized and the individual's self-interested nature was ignored; the assumption was made that people ought to be all altruistic and would be mobilized to work purely for the national and collective interest. In the meantime, information that decides an effective allocation of resources stays dispersed and there exists no omniscient and omnipotent supervisor who is aware of preferences of numerous individuals and information of production costs, nor is the supervisor able to timely grasp the extent to which various resources are short.

Under these two basic objective realities, for any reform or institutional arrangement to be successful, two basic constraints defined in the mechanism design theory need to be met: the participation constraint and the incentive

³ The hypothesis of self-interest can be applied in most, especially in regular circumstances; yet its application range, like any other theory or hypothesis, is subject to a boundary. On the occasion of abnormal circumstances like natural disasters, accidental events, war, earthquake or crisis, people would tend to be altruistic and selfless or even willing to sacrifice their lives (even animals have such an instinct, needless to say human beings); otherwise, they would fall to extreme individualism or egoism. Those who are opposed to this hypothesis tend to ignore this nuance. Detailed discussion can be seen in the article of *Thoughts and Methods in Economics* (Tian, 2008).

compatibility constraint (Hurwicz, 1972). These two constraints imply that agents should be able to benefit from reform or new institutional arrangements or at least suffer no loss; otherwise, they would oppose such reform or institutional arrangement. Only when an individual's revenue under a certain institutional arrangement is no less than his/her reserved revenue (not accepting such an institutional arrangement) will he/she be willing to follow this arrangement to carry out production, trading, distribution and consumption since an individual who pursues self-interest would not automatically accept a certain institutional arrangement but would rather ponder between the acceptance and denial of it. The incentive compatibility constraint requires reform and institutional arrangement to be able to greatly mobilize people's enthusiasm for work and production as well as make an individual's optimal objective option subjectively consistent with the decision-makers' objective to promote social and economic development. These two constraints are also two conditions that the agent (e.g. the reformer) must satisfy in making institutional arrangements under the optimal mechanism design theory, a branch of mechanism design theory in modern economics (Myerson, 1981). The participation constraint and the incentive compatibility constraint can be applied not only in the principal-agent relation in enterprises but also in macro-economic and industrial policy-making. These two constraints require consistency between the optimal act of individuals and enterprises under the same government objective and policy, namely, policy incentive compatibility.

These two constraints clearly exemplify the interaction between reform, development, and stability and in the meantime constitute the logical starting point of "enriching the people as a prerequisite for prospering the nation." For a nation, especially for China, where a highly centrally planned economy was practiced in the pre-reform times, rapid economic growth must be maintained if it aims to eliminate extreme poverty, and to become wealthy and strong. A crucial aspect of development lies in the mobilization of individuals to create wealth, which requires reform of systems that oppress or distort an individual's desire to create wealth so as to maximize the act of self-interest consistent with the national objective of self-prospering, and make the institutional arrangement satisfy the incentive compatibility constraint. Reform must be carried out to strengthen the nation and promote development; yet reform is built on social stability. In this sense, to satisfy the participation constraint is a prerequisite for a successful reform. In the context where individual income remains low and the traditional system remains dominant, reform in the first step is generally incremental and partial in order to maintain social stability and protect the majority of people from loss under reform. Such reform will greatly release production ability that was once oppressed and promote rapid economic development; however, as reform in the first step is partial and progressive,

factors that distort and constrain incentives for wealth creation still remain, and without further reform, development would encounter bottlenecks and sustainable development will not be achieved. Economic development that enriches people is the best way to secure stability. The income growth and strengthening of labor markets enable the partial participation constraint to grow into a strong participation constraint and thus make it possible to step up reform efforts.

In this way, this cycle of “reform-development-stability-intensified reform-sustainable development-dynamic stability” develops an interactive dialectical relationship between “reform, development and stability.” The positive functioning of this relationship will lead a nation onto a path of social harmony and lasting economic growth, which would provide the necessary economic foundation and conditions for the establishment of a prosperous nation. The essence of this interactive relationship is to enrich the people because only with constant efforts to enrich the people will they be mobilized to keep up a motive of wealth creation; and only with the advancement in enriching the people will the participation constraint become loose under development and in turn make it possible for intensified reform and further development.

2.2 Socioeconomic Stability and Harmony Can only Be Achieved when People Become Wealthy

The relationship between the participation constraint and stability clarifies the people’s current deep misunderstanding of stability and enables them to correctly comprehend its real essence. Rigid social stability managed by coercive administrative power is just superficial stability that fails to benefit or satisfy people; such stability will induce greater instability in the long run. Stability in a real sense is achieved by loosening the constraint to meet the aforementioned participation constraint; it is brought by reform and institutional arrangement that truly satisfy and benefit the people and is able to prevent social instability or turbulence under reforms. Social stability in a real sense is not short-term rigid static stability but long-term dynamic resilient stability.

First and foremost, under a system where people cannot become rich, basic stability might be maintained in the short term. Yet when the institutional arrangement fails to satisfy the incentive compatibility constraint to promote development and enrich people, the participation constraint will be impaired under global competition and population pressure. Hence, a system that fails to enrich people or promote development is undoubtedly unable to maintain long-term social stability, needless to say to enrich the nation.

Secondly, economic development requires an active participation from the majority of households to dedicate to wealth creation. In contrast, if most

households are unable to share the achievements or benefit from reform and economic development but only a minority of people do, or the nation itself benefits, a widening income gap or a wealthy nation with poor nationals will occur, which implies unequal income distribution. The imbalance between urban and rural development is becoming especially exacerbated as is shown in the enlarged income disparity between urban and rural residents despite an overall income growth in China. Income ratio between urban and rural residents has jumped from 2.57 (though once declined to 1.82 in 1983) in 1978 to 3.10 in 2012. Besides, the widening gap's contribution to overall inequality has been relatively large (Sicular, Yue, Gustafsson and Li, 2007). Such an unreasonable income distribution trend will ignite doubts about reform among the disadvantaged groups and further cause them to oppose reform since their participation constraint cannot be satisfied. Therefore, providing every person with an equal opportunity to grow wealthy is the fundamental way to solve the issues of the income gap (Tian, 2007; Shen and Tian, 2009a, 2009b) and achieve social stability.

Therefore, the establishment of a harmonious society and maintenance of social stability can be achieved neither by oppressive means nor by simple income redistribution but should be through reform like the designing of institutional arrangements that give incentives to provide individuals with equal opportunities and incentives to grow rich. Only a system of this kind is able to guarantee incentive compatibility between stability and development. Conversely, stability that is not achieved in this way is short-lived at the expense of development in the long run and would give rise to prolonged instability. Therefore, people must be enriched in the first place in order to achieve long-term social stability of dynamic resilience and a prosperous nation.

2.3 Sustainable Economic Prosperity and Development Can only Be Achieved through Enriching the People

Apart from a stable environment, the prosperity of a nation more importantly calls for sustainable economic development, without which true stability is not possible. The lasting prosperity of an economy is dependent on its ability to innovate and grow economically in a sustainable and balanced way. The Chinese economy witnessed a rapid growth rate of nearly 10% in the past three decades; however, such rapid growth is internally imbalanced and unsustainable as is markedly reflected from the following two aspects: (1) Economic growth receives insufficient drive from innovation and is achieved in a factor-driven manner. However, the factor dividend is facing a declining trend. The prerequisite of relatively abundant factor resources (population, resources, energy, environment and other factor resources) is now gradually shrinking to a tight

constraint. In particular, the advantage of a huge demographic dividend that China has been enjoying is fading away. China now faces a reducing proportion of working-age population as a proportion of the total population, but an increasing absolute population, and an expanding dependent population (see Fig. 1). China's population burden ratio is entering a sharp upward range, and the social pension burden tends to be heavier. (2) Economic growth benefits much from the overseas demand dividend and domestic demand is insufficient. However, with the continuous negative impacts of the international economic and financial crisis and the European sovereign debt crisis, etc., governments of countries in the world, especially developed countries, are now promoting the gradual rise of investment and trade protectionism out of political concern. As such, the global trade liberalization from which China has benefited for a long time is now facing a political constraint.

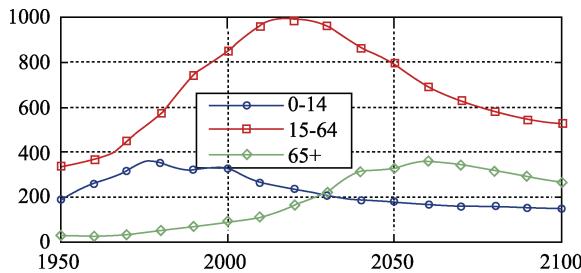


Fig. 1 China's Total Population by Major Age Group (1950–2100)

Source: Population Division, Department of Economic and Social Affairs, the United Nations.

In this context, there is a growing urgency in China for the transformation from overseas driven demand to domestic driven demand, from factor-driven to efficiency and innovation-driven economic development. Viewed in the long term, sustainable economic growth and development can only be advanced by the accumulation of knowledge and progress of skills. A nation's ability to innovate is dependent on its accumulation of human resources and incentives for innovation, its investment in education, its protection of intellectual rights and whether its incentives for innovative activities can satisfy the incentive compatibility constraint for innovation. The participation constraint and incentive compatibility constraint need an institutional arrangement that guarantees their satisfaction. If various institutional arrangements cannot satisfy the incentive compatibility constraint but are tolerant to copying and plagiarism, encourage imitation and fail to mobilize the motivation and initiatives of individuals to participate in innovative activities, it would be in vain however much input a nation has committed to lift its innovative ability. Therefore, to improve a nation's innovative ability, it requires many brilliant talents with enriching the

people as the orientation to provide individuals with incentives for innovation. Only when innovation becomes the first option of the individuals in building wealth is an economy able to maintain constant growth backed up by innovation.

Insufficient domestic demand in China's economy is a "chronic disease" that has been incurable for a long time. Some researchers attribute the main cause of China's sluggish consumption to the prolonged decline of proportional household income (Xie, 2007; Wang, 2010; Bai and Qian, 2010; see Fig. 2), the government's over-taxation, and the lagging public service infrastructures including social security, medical treatment and hygiene, education, ecological environment, which altogether results in a limited substantial rise in the households' performance income, benefits income and their increased tendency toward preventive savings. The core aspect to cope with China's insufficient domestic demand is to enrich the people, to give wealth back to the people, to keep wealth in the hands of the people and to provide necessary social security for the people. In microeconomic terms, to have people consume without too many concerns requires incentive compatibility between income distribution and social security. Institutional arrangements would be in apparent incompatibility with policy objectives if people are encouraged to consume on the one hand while their primary distribution in national income gets lowered and corresponding social security remains absent on the other hand. It should be noted that it is undesirable to solely put an emphasis on the increase of benefits income while ignoring performance income.

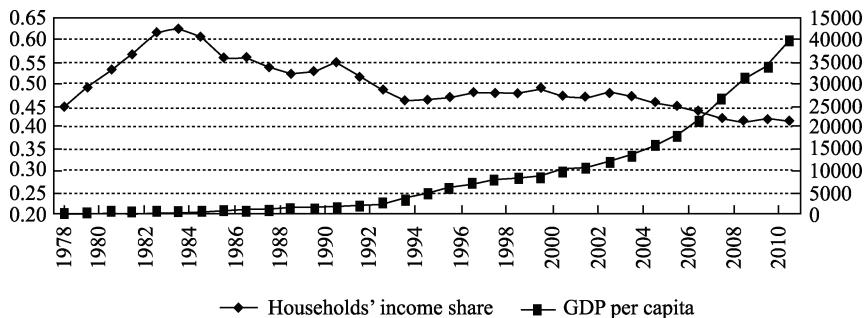


Fig. 2 China's Households' Income Share and GDP per Capita (1978–2010)

Source: Mao and Xue (2012).

Another potential threat to China's economic growth is the environmental resources constraint. China's rapid economic growth is accompanied by a heavy ecological and environmental cost along with the deteriorating quality of water, air, earth, and noise. If such situations do not improve in a fundamental way, China's reform, opening up and its all-dimensional modernization will be impacted and constrained, and people's living quality and even their survival

might be under threat. A crucial aspect of transition from an environmentally detrimental mode to an environmentally friendly one lies in the households' awareness of and efforts in environmental protection which is in turn decided by the households' marginal remark upon the environment and their participation ability in environmental protection. The households' marginal remark is mainly dependent on their income, so environmental protection would be a luxury to people when they are not wealthy. Under this circumstance, the environment is usually sacrificed for economic growth. Therefore, only after the people have been enriched will the top-to-bottom motive and stress on environmental protection be generated.

Through the above analysis on the inherent logic of economics, a basic conclusion can be made that the prosperity of a nation relies on the wealth creation by a good many individuals, and that the individuals' motive to create wealth requires the provision of adequate incentives enabled by institutional arrangements aiming at enriching the people through wealth creation. With appropriate incentives, "self-interest" might become the drive for economic development and social advancement, a proposition in consonance with the insightful remarks of Deng Xiaoping: "a good system incapacitates bad people from committing wrongdoings while a bad system disables good people from practicing good and can even turn them to the dark side."⁴

3 The Inherent Logic of Enriching the People

The goal set at the 18th National Congress of the Communist Party of China, to enrich the people, is the basis for prospering the nation. However, there still lacks a clear understanding of how to enrich the people. Many policies still take stop-gap measures, and pay attention to superficial aspects only, while neglecting fundamental institutional arrangements. These negative policies cannot help effectively enrich the people, but have become an obstacle to making people wealthy. According to the basic logic of economics, we believe that the first step to enriching the people is to give people basic private rights, of which at the core is the basic right to survival, the freedom of economic choice and private property rights. To ensure that people can fulfill these three rights, public power needs to be limited. It requires the devolution of power from the state to its people and from the government to the market, as well as restrictions and limitations imposed on the government's power. It should be noted that in the long-run equilibrium, a prosperous nation and rich people are based on fairness, justice, personal happiness and other value elements; otherwise there can be no

⁴ See *Selected Works of Deng Xiaoping*, Vol. 2, People's Publishing House, 1994, p333.

long-term and sustainable wealth for the people, and thus no long-term prosperity for the nation. That is to say, fairness, justice and personal happiness are necessary conditions for the people's sustainable wealth.

3.1 To Enrich the People, Private Rights Must Be Given

Two basic mechanisms for resource allocation are planning and market. A planned economy is in essence what Marx referred to as “large social factory” with the central planning authority using administrative means to allocate resources. Its effective functioning implies two assumptions: first, the central planning authority has all the information on every economic activity of the whole society, including the status of material resources, human resources, technical feasibility, and demand structure (complete information assumption); second, the integration of all social interests, which means there exist no separated interest subjects and different judgments of personal values (sole interest subject assumption). “The labor-power of all the different individuals is consciously applied as the combined labor-power of the community.”⁵ Without these two conditions, a centrally planned system will hardly function effectively because of the extremely high costs of information and incentive. However, in real economic life, individual self-interest and information asymmetry are exactly the two basic constraints of objective reality that we have to face. At the current development stage of human society, most people will not “consciously” see themselves as the combined labor-power of society nor do they truly disclose private information, so the resulting costs of information and incentive make it difficult for the planning system to achieve an efficient allocation of resources.

Adam Smith (1776) proposed in his *Wealth of Nations* that the market as an ‘invisible hand’ can guide the resources to achieve efficient allocation. The “first fundamental theorem of welfare economics” strictly proves that the market economy can achieve efficient resource allocation, with the basic behavior assumptions of local non-satiation of personal desires, and that a free competitive market system leads to efficient allocation of resources when certain technical constraints are met.⁶ Schumpeter (1934) demonstrated the effectiveness of the market mechanism from the perspective of the innovation incentive; Hayek (1945) illustrated the superiority of the price system of the market mechanism compared to that of the planned economy from the viewpoint of solving the problems of dispersed knowledge and information; Debru and Scarf (1963),

⁵ See Marx, *Capital*, Vol.1, People's Publishing House, 1975, p95.

⁶ See Mas-Colell, Whinston, and Green (1995) or Tian (2010), chapters on General Equilibrium Theory.

through proving the concept of the economic core⁷ first studied by Edgeworth (1881), demonstrated that under very general technical conditions, even with no prior institutional arrangements, once the individuals have basic private rights and are allowed to fully compete, voluntarily cooperate, and voluntarily exchange, the result obtained is the same as what is produced by competitive market allocation, thus achieving the efficient allocation of resources and the naturality and objectivity of the market system. Hurwicz further proved the uniqueness and effectiveness of the market mechanism, that is, under the information asymmetry constraint, as long as everyone or at least someone aims at the maximization of personal interests, then the competitive market mechanism with clear property rights is the only and most informational efficient mechanism that achieves an efficient allocation (Hurwicz, 1972, 1973, 1979, 1986; Tian, 2002, 2003). The core features of the market mechanism are the requirements of clear property rights, economic freedom and full competition for individuals, and it is proposed that the exchange of resources under the above three conditions can achieve efficient resource allocation. Therefore, the market mechanism is not a man-made invention, but the outcome of social choice with its own inherent logic that is the common wealth of mankind.

The individual's possession of basic private rights is the most fundamental prerequisite for the effective operation of the market mechanism with voluntary exchange as its basis. Therefore, under the objective reality of self-interest, the proposition that "private rights need to be given if people are to be enriched" is the single means complying with the inherent logic of economics to enrich people. In a broad sense the so-called private rights can be summarized as the following: the basic right to survival, the freedom of economic choice, and the private property rights of an individual.

First of all, the first step to enrich the people is to guarantee the people's basic right to survival, which is not only a prerequisite for fulfilling other private rights, but also a necessary condition to achieve social harmony and stability and to ensure stable economic development. If the basic right to survival of an individual can hardly be guaranteed, then their freedom of choice and private property rights would be wholly unrealistic. The right to survival is hence the most fundamental right. At the same time, due to the limitations of an individual's capabilities or opportunities, there will inevitably be some people

⁷ Economic Core Theorem has profound economic connotation and fair policy significance which reveals the endogeneity and evolvability of a competitive market system. This theorem basically implies that when a society's resource distribution is in the status of economic core, there are neither factions that are discontented with such distribution trying to control and use their resources to increase their own benefits nor forces or factions that pose a threat to society. In this case, the society will enjoy stability. In economic terms, the status of economic core satisfies the Pareto optimality and participation constraint.

who cannot survive the competition. Thus, the government and society need to provide protection to guarantee everyone's right to survival, otherwise without satisfying the individual participation condition, it will be impossible to achieve social security and order, the effective operation of the market, or economic development.

Secondly, with an individual's right to survival ensured as a basis, "enriching the people" requires giving people adequate economic choice to let them enjoy full freedom in economic activities on the premise of doing no harm to the interests of others, which is known as "deregulation." In a decentralized decision-making market mechanism, the economic freedom based on voluntary cooperation and voluntary exchange plays an essential role, which is the most fundamental precondition for ensuring the optimal allocation of resources by a competitive market mechanism. Analysis on China's experience of its successful economic reform shows that despite any other crucially important issue, the uttermost significant factor is to give people more freedom of choice in their economic life. China's reform over 30 years has benefited from many desirable decisions, but the most significant one is relaxing policies, i.e., providing producers and consumers with more freedom of choice. Evidence from both rural and urban areas in China shows that wherever there are loose policies or a greater degree of freedom, there is normally higher economic efficiency with a considerable increase of household income.

Thirdly, to enrich people requires giving people private property rights with corresponding protection. The so-called private property rights refer to the property rights entirely defined in the exercise of an individual, which excludes others from exercising the same rights. Private property rights have great advantages in information and incentive: once individual property rights are protected, personal interests and property rights will be consistent, the fruits of labor and property income are not shared, and personal interests are fully protected, which will greatly motivate people to work hard and create wealth with a strong sense of competition. Apart from this, private property rights will inevitably lead to a market-oriented operating manner with decentralized decision-making, where symmetrical information tends to be more easily produced along with flexible mechanisms and a fast reacting market, which altogether become the outcome of incentive compatibility and provide a necessary condition for a prosperous nation. The fundamental reason for the huge success of China's economic development is essentially that the private economy has become the main body of the economy. It is an undeniable fact that the proportion of state-owned and state-controlled enterprises industrial output value of the total industrial output value has dropped sharply. Essentially speaking, to maintain the long-term sustainable development of the Chinese economy, we still need to further develop non-state owned enterprises, especially private

enterprises, which is the fundamental way for long-term economic development.

3.2 To Protect Private Rights, Public Power Must Be Limited

The statement that “to protect private rights, public power must be limited” is the inevitable outcome under the inherent logic of protecting private rights. It is also the lesson drawn from the development trap currently facing or already experienced by many developing countries in Africa, Latin America and other regions. Neither the real implementation of an individual’s basic right to survival, freedom of economic choice and private property rights, nor the effective functioning of the market economy can be achieved through the simple practice of laissez-faire or democratic politics. To ensure that individuals have true freedom and strong protection of property rights and contracts, there must be an effective government. It is required that government has the authority and state power to maintain basic legal order, social order and economic order, to prevent unlimited laissez-faire anarchism, to guard against external aggression and to safeguard national security and stability, as well as corresponding incentives to perform its duties. In this regard, Fukuyama (2006) once explored the role of state in development, taking America as an example. He believes that the scope-narrowing of state activities and the strengthening of state capacity must be carried out simultaneously. This requires that an effective government must have the incentive and ability to protect private rights, to ensure the effective operation of the market, and to provide an effective institutional environment to enrich the people. For a government with coercive power and administrative monopoly power that pursues the maximization of its own interests, it must establish itself as a limited government with proper positioning in order to become an effective government.

The necessity for a limited government originates from the distinctive attributes of government. First, government possesses state coercive power that is exclusive from other economic entities, and such enforceability is indispensable for government to perform its duties and act as a “helping hand.” However, this tool may also be abused or misused, which leads to the violating or looting of private rights, and thus becomes the underlying support for the “grabbing hand” (Shleifer and Vishny, 2002). Second, government is also an “economic man” participating in allocation of resources. Government possesses resources, employs labor and has a large amount of consumption in the economy; meanwhile, it produces many items, including both public goods like national defense and police and private items (for instance, railways, telecommunications and electricity companies are owned by the government in China), thus the government bears the attributes of an “economic man,” that is, having self-interest, which is something in common with private enterprises. Third,

government as an organization is composed of many individuals with different objectives, requiring these individuals to perform its functions. Thus, under self-interest and information asymmetry constraints, the issue of incentive compatibility has to be dealt with, namely, how to make government employees use public power effectively for civil service and the protection of private rights, rather than to abuse or misuse public power.

Thus, government as an unfair participator in economic resource allocation, on the one hand possesses the state coercive power and administrative monopoly power, and on the other hand faces a serious incentive problem. Therefore, to ensure that the government has the incentive and ability to do the right thing, it has to be a limited government. Why do the vast majority of countries in the world adopt market economy, yet not many countries have established a real standard market economy? The reason is that they have not built a legal environment and a democratic system to establish a reasonable and clear definition of the governance boundary for their government, market and society, 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. It is an innovation of modern society to restrict government by the rule of law and to define the boundary between government and individual rights and clarify the governance boundary between government, market and society by pre-established rules.

In summary, an unlimited omnipotent government and an effective government are not incentive compatible. Under the self-interest and information asymmetry constraints, it cannot be guaranteed that an unlimited omnipotent government would consciously protect private rights, provide the required public goods, or become an effective government. Therefore, only by limiting public power can we protect private rights, and only when private rights are protected can people become rich. This is both the inherent logic based on the fundamental principles of economics and the practical experience of world powers in history as well.

4 Interpretation of the Inherent Logic of “Enriching the People as a Prerequisite for a Prosperous Nation” from China’s Reform Experience

In recent years, the debate on the “China model” has emerged in intellectual and academic circles both at home and abroad, and some scholars have even put forward the concept of “China’s economic miracle” in economic development based on China’s achievements since reform and opening up (Lin, 2007). However, there are also scholars holding different views, arguing that China’s

economic development bears no peculiarities (Perkins, 2005; Qian, 2010; Tian, 2010b). At present, this debate not only concerns how to interpret China's reform experience over the past 30 years; more importantly, it is related to judgments on China's development stage of reform as well as its direction of reform in the future.

This paper holds that as far as the inherent logic of reform and development is concerned, China's experience bears no special and exceptional nature. The success of China is precisely from following the basic requirements of this logic, while the problems in the process of development actually arise from violating this inherent logic. The decentralization and deregulation, giving benefits to the people and encouraging private economic development implemented in reform and opening up all reflect this logic in reform of enriching the people first. By means of the competition between local governments under private capital market constraints, a strong restriction of government power is formed and the economic activities of government tend to be effective, which has stepped out of the historical trap of decentralization of power featuring "disorder." On the other hand, policies and institutional arrangements that incur competition with people for benefits but provide no assistance to people in a market economy are contradictory to the development logic of enriching the people first. At the same time, the lack of democratic supervision of government power, the abuse of public power due to lagged development in the rule of law, and the unprotected private rights do not comply with the prerequisite of "limiting public power and protecting private rights" for enriching the people. This kind of violation of the inherent logic of prospering the nation through enriching the people has imposed a serious threat to the sustainability of China's economic development, and the vested interest groups thus formed have become a strong resistance to the further reform of enriching the people.

Although the inherent logic followed by China's reform is not special, China has accumulated valuable experience through its exploration of a path of "prospering the nation through enriching the people" with Chinese characteristics, which has provided helpful reference for the economic development of the world, especially for developing countries that need institutional reform.

4.1 Taking Constraints into Full Account and properly Handling the Relationship between Reform, Development and Stability

China's original planned economic system must be reformed to achieve development, but the introduction of a new reform measure or institutional arrangement must be feasible, enforceable, and must satisfy the objective constraints. Meanwhile, it is also expected to minimize the risk of implementation to avoid social, political and economic turmoil. This actually

involves an interaction problem of “system reform and economic development, which should start first?” From a developing and dynamic point of view, for a very poor, backward and underdeveloped country that has not yet achieved initial economic development with a very low level of initial income (for instance, the per capita income of China was only \$300 or so at the beginning of reform), the intensity of institutional transformation should not be too high since a major reform is bound to involve the interests of many people. However, autonomous and incremental reform can be carried out to promote initial economic development through decentralization and deregulation. Why can China achieve such great success in reform? The reason is that this reform fully meets the two basic conditions repeatedly mentioned in the design of the economic mechanism: one is the participation constraint which sees the overwhelmingly majority of people benefit from reform; the other is the incentive compatibility constraint which mobilizes people’s enthusiasm to create wealth. Moreover, development should take social stability as a prerequisite. If we rush to implement overall privatization characterized by “shock therapy” and try to transform into a market economy with one once-and-for-all step, it will inevitably cause enormous social conflicts, waste social resources, incur opposition from the vast majority, and thus lead to failure. Even for a relatively affluent country with a high income level, it will also give rise to considerable social conflicts and waste of social resources; Russia and Eastern European countries are typical negative cases in this regard.

Therefore, the feasibility of satisfying the constraints is a necessary condition to determine whether a reform measure or institutional arrangement is conducive to economic development and a smooth systematic transition. In the economic transition of a country, the reason for the feasibility of an institutional arrangement is that it conforms to the institutional environment of a particular development stage of that country. For China, it means that reform must be adaptable to China’s national conditions in order to achieve stability and development. Feasibility requires a consideration of varied constraints encountered before taking correct actions; otherwise, its implementation will not be possible.

Only by taking full consideration of the constraints can we properly handle the relationship between reform, development and stability. If a reform or institutional arrangement does not satisfy the participation constraint, there will be no stability, let alone development. Therefore, the stability issue should first be addressed in institutional reform so that all individuals are willing to take part in the new system. However, with stability only, if the incentive compatibility constraint is not satisfied, people will not have the incentive to contribute for the good of society or improvements in efficiency, and there will be no development. Even if the system can realize temporary stability, yet from a long-term and

dynamic point of view, without development, the participation constraint can hardly be maintained for long with population growth, resource exhaustion and intensified external competition, which will make it difficult to satisfy the participation constraint, and thus affects stability. Therefore, there can be no long-term stability without development. The reason for the failures of change and reform in China's history is that they did not satisfy these two constraints of participation and incentive compatibility, and could not address the two necessary conditions of individual rationality and incentive compatibility. Hence the two constraints give a complete description of the interactive relationship between "reform-development-stability": reform promotes development in a stable condition, while development benefits ordinary people (loosening the participation constraint) and thus promotes stability, creates conditions for intensifying reform and advances further economic development.

The dialectical relationship between reform, stability and development also determines that China's reform and institutional transformation should take a gradual approach. Although the reform goal is clear, it is not equal to the process of implementation. China's national conditions must be taken into account in reform, that is, reform should be adaptable to the initial social material conditions and China's economic system environment at that stage. One major reason why China and Russia or other Eastern European countries have chosen different reform paths is that their initial material (natural endowment) conditions are different. First, China and Russia differ in initial economic conditions. At the beginning of reform, the per capita GDP of Russia and other Eastern European countries was many times higher than that of China; after radical reforms, their GDP dropped by 50% or more, but the per capita GDP was still over \$1000. When China started its reform, the per capita GDP was only \$300, and with 50% drop it would have only been \$150. Imagine what the consequences would have been had that actually happened? It has been previously mentioned that a necessary condition for economic development is social stability and the stability of state power, so there are no conditions for radical reform in China. Second, China and the West have different histories and cultural traditions. Russia belongs to the western civilization, which pays more attention to democracy, the rule of law and the rule of doing things. China, on the contrary, lays more emphasis on the respect for traditions, The Doctrine of the Mean advocated by the Confucian culture and the balance of doing things, rather than on democracy and the rule of law in many cases. Therefore, fundamentally speaking, the difference in these two initial conditions determines the distinctive reform paths of China and Russia.

Therefore, the initial conditions for institutional transformation in China determined that reform must be gradual and first launched in rural areas where the potential negative impact from reform is the least, and that urban reform

should begin with incremental reform and not commence with ownership reform in a real sense until the non-state economy has developed to a certain level with the market system gradually taking shape. It is not a path pre-designed since the beginning, but a step by step process of “testing each step before taking it.” One crucial aspect of its success is following the inherent logic in the exploration, properly handling the dialectical relationship between reform, development and stability, and achieving the positive interaction between a smooth institutional transition and rapid economic development.

It is important to note that while the utmost importance of constraints should be recognized, they should not be resorted to as an excuse indiscriminately for any matter, such as blindly opposing democracy, the rule of law, and administrative and political system reform. Quite a few people resist market reform, democracy and rule of law as a result of having a deep misunderstanding of the constraint of national conditions. Here the misunderstanding is represented in two major aspects. First, the constraints are taken rigidly and statically for a long time. In fact, in the long run, with the deepening of reform and economic development, the boundary of constraints and the participation condition are constantly advancing and expanding. Many unimaginable things 30 years ago seem to be only too common today. The same is true of democracy and the rule of law. With social and economic development and the improvement of people’s living standards, national conditions (that have also been slowly evolving) will have a stronger demand for spiritual and political civilization such as democracy and the rule of law. Second, issues concerning principle and issues concerning approaches are confused. An absolute demand for democracy and the rule of law is a matter of principle, whereas how to achieve them is about manners and approaches. Apparently, it is undesirable to abandon general principles because of special national conditions. However, the objective is not equal to the process and democracy and the rule by law is not to be achieved instantly. Thus, we need to adopt appropriate manners, methods and steps to realize the goal through a step by step process. This can and needs to be explored, and is not an impossible mission.

4.2 Recognizing Individual Interests to Promote Market-Oriented Reform

On the basis of ensuring the overall stability of people’s lives, China’s reform and opening up has been able to maintain a sustained and rapid economic growth in the transition from a traditional planned economy to a modern market economy. An important reason for this is recognizing personal interests and giving individuals the right to create wealth, and under those premises, giving economic freedom, adopting decentralized decision-making and introducing the incentive mechanism.

First, to recognize personal interests, government must give people the right to create wealth through work, and propose to allow some people to get rich first. Previously, the ideology of equalitarianism in the planned economy dominated the income distribution among ordinary people; individual interests were taken entirely subordinate to collective interests and any idea or effort to get rich would be criticized as the residue of capitalism. As a result, everyone was waiting for collectivism's "egalitarian distribution" and this led to collective poverty. The series of policies then carried out in China of the rural "Household Contract Responsibility System," encouraging the development of the individual economy and private economy through self-interest and allowing some people to get rich first actually recognized the personal interests of farmers, self-employed laborers and entrepreneurs to arouse personal initiatives to create wealth.

Second, as it is recognized that individuals have different interests, government must give people more economic freedom in order to bring the individual potential of wealth creation into full play. We need to give economic freedom to individuals, so that each person enjoys more freedom of economic choice without harming the interests of others. This is the so-called "deregulation," which means giving producers and consumers more freedom, to let the government gradually withdraw from competitive fields, and to reduce administrative intervention in the market. China's sustained and rapid economic growth in the past is precisely the result of government decentralization to the market, while in reality market imperfection stems from excessive government intervention and inadequate government regulation and institutional supply.

Third, to implement decentralized decision-making: the corporate sector or the individual rather than the higher authorities must make production and consumption decisions, which is known as "decentralization." It is because of information asymmetry, which cannot be fully obtained by higher authorities, that decentralized decision-making is expected. The incentive mechanism can be employed as a means of decentralized decision-making of indirect control to motivate people to do what decision-makers want to do, or to achieve what policy-makers want to achieve. Decentralized decision-making greatly reduces the cost of information processing and transmission, so economic information is more effectively used. The mandatory economic mechanism mainly adopts a centralized decision-making mode, while the market mechanism mainly adopts a decentralized decision-making mode.

Fourth, to introduce the incentive mechanism: faced with self-interest and information asymmetry, institutional arrangements are required to meet relevant incentive compatibility conditions to make individual interests and social objectives compatible in order to guide personal efforts towards wealth creation rather than rent-seeking, free riding, or violation of the interests of others. In the process of reform and opening up, the fields with incentive compatibility in

personnel and welfare system reform develop well; on the contrary, in such fields as higher education and medical care where there are still incentive incompatible institutional arrangements, the granting of individual economic freedom will lead to a distortion of incentives, thus impairing the interests of students and patients.

4.3 Promoting Competition among Local Governments and Opening up

The effectiveness of the market economy calls for a limited and effective government to guarantee private property rights and order in market competition. In the governance structure of the Chinese government, a central issue in reform is the balance and incentive between central and local governments. Since 1949, China has been in the institutional framework of political centralization. Although decentralization to local governments has been tried many times to mobilize their enthusiasm, for lack of the constraints from market or grass-roots, decentralization has caused fierce competition among local governments for central government resources or public resources such as bank credit, which has led to the tragedy of the common and the dilemma of “disorder with decentralization, deadlock with re-centralization.” In the 1990s, with the development of market-oriented reform and opening up, particularly with the entry of large-scale foreign direct investment (FDI) and the development of private capital, local governments had to compete for FDI and private capital and thus constituted a constraint from the capital market on the local governments in pursuit of GDP growth, so that the behavior of local governments has tended to be efficiency-oriented. It was not until then that the relation of central and local governments stepped out of the vicious circle of “disorder-deadlock.” As opening up imposes constraints on government behavior, it also expands the freedom of individual and corporate transactions, makes it possible for capital, labor and technology flows to be distributed in the global market, and in particular, it opens the door for China to introduce and imitate advanced foreign technology, which contributes considerably to solving the problem of the source of continuous growth posed by an inadequate self-innovation capability.

However, while the governance structure of political centralization and fiscal decentralization has promoted China’s economic growth, the problems caused by it have become all the more prominent. This governance structure has solved the short-term economic growth problems, but led to structural distortion in government behavior. Local governments give top priority to GDP growth, but ignore people’s livelihood and the protection of household interests; local governments even collude with business and bring damage to private rights, which have resulted in intensified social conflicts and instability. The root for this is that despite the constraint from the capital market on local governments, the rule of law in China is still underdeveloped, democratic supervision is inadequate

and the migration of residents is strictly restricted. Thus, the residents cannot fully use the law to protect themselves, nor can they impose constraints on local governments through voting rights or migration. If private rights are not guaranteed, people's livelihoods cannot attract substantial attention from the government, and growing rich will become the endowment of only a few people, with most people unable to share the benefits of economic growth. Thus, the conflict between development and stability will become increasingly obvious, the cost of the traditional way of maintaining stability by coercive administrative power will become higher, and the central government will find itself all the more powerless in acting as a "fireman."

Thus, the miracle of China's economic growth can be attributed to the fact that reform and opening up follow the inherent logic and path of prospering the nation through enriching the people. Economic growth comes from the recognition of individual interests, the protection of private rights and the reduction of government intervention in the market, so the reform direction of letting the market play an increasingly leading role with a gradual and corresponding reduction in the government's role should not be changed. Current problems of various kinds, such as over-sized government, excessive government intervention in the economy and the lack of restrictions on public power, actually stem from not fully complying with this inherent logic. Over-sized government causes the invalidity of both government and market. Government itself abuses and misuses power because of the possession of excessive unlimited power. At the same time, government behavior of competing for profits with the people leads to an inefficient market and the current situation of a wealthy nation with poor nationals. Therefore, future reform should be directed towards further expanding civil rights and limiting the government's public power in order to ensure the effectiveness of the market and the government at the same time.

From the above analysis it is seen that China's reform experience well answers the question of Douglass C. North in China's institutional environment, that is, under China's national conditions back at that time, how can it transform from a traditional system detrimental to economic development to a desirable system conducive to economic development, and under what conditions can China transit from a non-ideal status to an ideal status? The answer is that at the beginning of China's reform, with low initial endowments and per capita income, radical reform is not feasible, and the only way is through autonomous incremental reform through deregulation and decentralization, which then creates conditions for further intensifying reform and launching overall market-oriented reform. This "reform-development-stability-intensified reform-sustainable development-dynamic stability" pattern constitutes the path and characteristics of China's reform, making China embark on a self-prospering path of social harmony and continuous economic boom and growth. For other countries with

different initial conditions, they might take different paths of reform.

5 Conclusion

A basic conclusion of this paper is that “enriching the people is a prerequisite for prospering the nation” and enriching the people requires “the limiting of public power while protecting private rights.” This conclusion is a lesson drawn from China’s 30 years of reform and the problems that have arisen in this process. After getting out of its closed and semi-closed planned economy, China enjoyed the great potential and momentum brought by domestic reform and opening up to the outside world, which generated positive impacts that considerably outweighed the downsides from the government-dominated economic development and social governance. Despite the negative aspects from the government’s excessive intervention in the economy, China’s successful reform lies in its basis on national conditions, compliance with the inherent logic of prospering the nation through enriching the people as well as its in-depth learning and utilization of the achievements of other countries. Meanwhile, China’s successful reform itself is of no peculiarity or exception. On top of that, the government’s dominant role in the economy at present is an interim feature in China’s reform process rather than a stable or mature long-term development mode.

If China’s experience is explored simply through an horizontal global comparison without this interim development feature being recognized, it is liable to mistake resistance for drive, friction for power, short-comings for strengths and transitional institutional arrangements under constraint for the ultimate objective, which may result in a state of satisfaction with the present situation and the severe weakening of consensus on reform and the endogenous power of reform. In this sense, there does not exist the so-called “China Model” with the government playing a leading role as a relatively mature, stable, and widely applicable development model, but rather a Chinese development path or development experience featuring the inherent logic of “prospering the country through enriching its people” that can be employed by countries all over the world. Hence, China’s reform is far from accomplished and it is supposed to strictly observe the inherent logic of “to enrich the people, private rights must be given, and to protect private rights, public power must be limited” in China’s promotion of market-oriented reform.

The deep-rooted contradictions faced by China today, especially the contradiction of a wealthy nation with disadvantaged nationals, stem from its violation of the inherent logic discussed above. The contradiction can never be eradicated through a simple increase of social benefits; rather, the welfare institutional arrangement must be able to coordinate an appropriate proportion

between benefit income and performance income. On one hand, a necessary welfare system is needed to guarantee basic living allowances; on the other hand, reform should be further deepened, public power should be limited, private rights should be ensured and effective market and government should be established to develop and improve performance income, to encourage people to work industriously, and to secure economic growth so as to properly handle the dialectical relationship between reform, development, stability and equality in a fundamental way for achieving sustainable economic growth, national prosperity with wealthy people, the great rejuvenation of the Chinese nation, and long-term peace and stability.

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