REMARKS ON CHINA'S 11TH FIVE-YEAR PLAN:
Another Major Step in China's Transition to A Market Economy

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China is about to adopt its 11th five-year plan, setting the stage for the continuation of what is probably the most remarkable economic transformation the world has ever seen, improving the well being of almost a quarter of the world's population. Never before has the world seen such sustained growth on a scale remotely as large. For the past quarter century, China has been growing at 9%, and per capita income has quintupled (from $220 to $1100).[2] The only growth experience that is of some comparability is that of the so-called East Asian miracle economies with eight of the highest performing economies averaging growth of per capita income of 5.5% during 1965-90 but that was both somewhat slower and on a much smaller scale than the growth of the Chinese economy in the past quarter century. Previous economic revolutions—like the industrial revolution of the nineteenth century—had seen growth rates peak at around 2 to 3%**.**[3] The golden age of growth in America in the fifties and sixties saw growth rates in the same vicinity. China's growth has been three times these numbers.[4] And never before has there been so much poverty reduction. The fraction of the Chinese population living on less than $1 a day has fallen from 63.8% in 1981 to 16.6% twenty years later.[5]

Part of the key to China's long run success has been its exceptional combination of pragmatism and vision, constantly adapting to the changing needs and circumstances, but keeping a view of the road ahead. With this plan, even the nature of what is meant by planning is changing. This is not a plan, as this term was understood in the days of Central Planning. It recognizes that, as China moves to a market economy, a Plan is not about material balances or directions about how much of each commodity should be produced. Rather, it concerns a vision of the evolving nature of the economy, and of the

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[2] See the World Bank's *World Development Indicators* - GNI per capita, Atlas method (current US$), from 1980 to 2003 (the most recent year available).

[3] See: Crafts, Nicholas. "Productivity Growth in the Industrial Revolution: A New Growth Accounting Perspective." *Journal of Economic History*, vol. 64, no. 2, June 2004, pp. 521-35.

[4] Of course, there are disagreements about the accuracy of the numbers. But almost surely, China's true growth in 2003 and 2004 was higher than the 9% reported. China's GDP measured in purchasing power parity—adjusting, in other words, for the cost of living in China—is close to 4 times the official statistic, which is based on the exchange rate. If one used GDP as measured by the exchange rate, but assumed that the market exchange rate was overvalued by, say, 20% in 1998, as the government intervened to prevent its exchange rate falling in tandem with those of the other East Asian countries, and, by 2005, was undervalued by 20%, then "real" growth so measured would have averaged another 5 percentage points higher.

[5] See: The World Bank's Reducing Poverty Sustaining Growth Initiative, http://www.worldbank.org/wbi/reducingpoverty/index.html.

role of government; it indicates the priorities both for expenditures, and institutional and policy development; and provides a framework for coordinating economic activities.

One of the distinctive aspects of the Plan is its comprehensiveness. One of the development lessons to emerge in the late 90s is that successful strategies have to be comprehensive. Some complained that a comprehensive strategy would lack focus. But the experiences of earlier development efforts were telling: without a comprehensive vision, one risked failures, as policy makers, for instance, improved price incentives for agricultural output without paying attention to the supply of inputs or credit or marketing and physical infrastructure; as they opened up new trade opportunities, without the infrastructure or finance to take advantage of these new opportunities or privatized rapidly without attention to the regulatory regime or property rights and the incentive structure.

The vision of the economy underlying China's 11th five-year plan is informed by a vision of society, one which sees success not just as increase in GDP but more broadly. While much of the rest of the developing world, following the Washington Consensus, has directed its efforts at the quixotic quest for higher GDP—with misconceived policies and poor results[6]—China has once again made clear that it seeks sustainable and *more* equitable increases in real living standards.

As China goes about assessing success, it should use metrics that reflect this broad vision. For instance, there are countries—like my own—where GDP is increasing, but so too is poverty, and real median family annual income is actually declining, as it increasingly becomes a rich country with poor people.

China's success in reducing poverty as it moved to a market economy is commendable; but there are disturbing increases in inequality. (Its Gini coefficient has reached .47) And as this year's World Bank *World Development Report*, emphasizes inequality is a concern in itself; it affects the nature of our societies, including the nature of political processes—where those with wealth use that wealth, in one way or another, to perpetuate their favored position. As China moves to a market economy, almost surely the influence of such inegalitarian forces (e.g. corporate interests) will grow, a theme to which I will return later.

As China has moved to a market economy, there has been a concern about the weakening of social safety nets, particularly in the rural sector, with consequences for living standards, reflected, for instance, in life expectancy. In spite of the fact that China's per capita income has increased more rapidly than India's, the gap in at least some of the social indicators seems to have narrowed.

As was discussed in the China Development Forum in 2004, China is entering a phase of its growth in which it is increasingly making demands on natural resources and the

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[6] See, for example, my paper "The Post Washington Consensus" forthcoming, *From the Washington Consensus towards a New Global Governance,* Oxford University Press, available at www.policydialogue.org.

environment, in ways which are almost surely not sustainable. Oft quoted statistics bring home the magnitude of the concerns: while China's GDP accounted for only 4% of global GDP in 2004, its share of global energy usage was three times larger, and it consumed 28% of the world's rolled steel and 50% of its cement.

I think, accordingly, it is imperative that as China tries to assess its success, it look askance at GDP, focusing more on several other measures: (1) at *green net national product*, taking into account the depletion of natural resources and the degradation of the environment. Even if, say, environmental degradation is imperfectly measured, it is better to attempt to measure it than to ignore it; we know that "zero" is not the right number; (2) at median income, not mean; (3) at measures of inequality, like the Gini coefficient; and (4) at social indicators, like life expectancy and educational attainment, *and the distribution of these variables.*

In this short paper, I can but briefly discuss a few of the topics that are taken up in the 11th five-year plan. Each plan sets the stage for the next, and I conclude with a discussion of a few areas that perhaps received insufficient attention, and to which subsequent plans might appropriately give more emphases.

A Market Economy with Chinese Characteristics

At the onset of China's march to a market economy, it was made clear that the country sought a distinctive form of the market economy. It had recognized what some naïve advocates of market economics had not: that there was not one form of market economy but many. The Scandinavian form of market economy is different from that of America or much of the rest of Europe. It has a high level of social protection, a high level of taxation, a high level of social services, a large role of government in helping workers move from one job to another. And, to go back to the broader measures of success to which I refer, it is the most successful version of the market economy. The performance on the Human Development Indicators is far better than that of the United States. Even in the area of narrow economic performance, while Sweden's GDP per capita annual growth rate (1990-2001) of Sweden has been robust (1.7%[7]**),** poverty is low and those in the middle are doing well.

Also, the particular form of market economy in a specific country changes over time as circumstances change. The post-World War II social democracies of Europe are markedly different from their nineteenth century antecedents. The economic system envisaged by the Roosevelt Administration's New Deal, which helped to get the country out of the Great Depression, was markedly different from that a decade earlier. The debate about the appropriate economic role of government remains heated both in the United States and Europe—there is no consensus. (Later I shall discuss the role that economic science, as well as ideology and interests play in this debate.)

There are other metrics of societal development for which the particular form of the market economy matters as evidenced by the many other dimensions in which the

[7] See: http://globalis.gvu.unu.edu/indicator_detail.cfm?Country=SE&IndicatorID=45#row.

Scandinavian region excels as well: greater transparency of government, better protection of individual rights, a much, much smaller fraction of its population in prison (this is an area in which, unfortunately, the United States does increasingly differ from other advanced industrial countries—with approximately ten times the number of people in prison per thousand population.)

China, in its 11th five-year plan reiterates an emphasis on a "harmonious society," which I take it reflects an emphasis on "balance," such that: (a) disparities be limited between urban and rural areas, between the advanced and less advanced regions, between the rich and poor within any region; (b) there be a balance between the government and the other parts of the society; and (c) there be a balance among the sectors of the economy. Such a balancing act is necessary both for social and political stability and for economic progress, as I have defined it broadly above. I should add but three points:

First, modern economic theory has emphasized the need for a balanced approach, as we have come to understand the limitations of the market. Too often, Adam Smith's invisible hand, which is supposed to result in individuals' and firms' drive for profits leading to overall societal well-being, is invisible because it's not there: in general, when information and competition is imperfect and markets are incomplete—that is, always—markets are not (Pareto) efficient. Government can play an important role. Often some combination of ideology and special interests get in the way of recognizing the policy implications of the theoretical case for an appropriate balance between the state and markets. But as we look across societies, problems arise as often from too little government as from too much government; more frequently, though, the problem is that government does less of what it should do and more of what it should not do. Even if the problem in the past in China has been that government took too active a role in the economy, one must still guard against the danger that in overreaction, the government will undertake too small a role.

Secondly, today, we are increasingly recognizing a tri-partite division, between government, the profit oriented private sector, and civil society, which includes cooperatives, the not-for-profit sector (universities, hospitals), and NGO's. Even in America, traditionally thought of as a quintessentially "capitalist" economy, cooperatives play a vital role, even in business. They are particularly important in the rural/agricultural sector—for instance, the most important producers of diverse products from butter to raisins are cooperatives. In education, while the for-profit firms have been marked by fraud and scandal, and a few of our world-class universities are in the public sector, most of the world-class universities lie in the not-for-profit sector.

Thirdly, maintaining this balance will not be easy. There are strong underlying forces that are leading to increases in inequality. Some of these are related to the normal functioning of the ordinary laws of supply and demand working their way through the competitive market place. Globalization and technology have worked together to increase the demand for certain types of skills that are in short supply, and wages of individuals with those skills naturally increase in response. Standard economic theory had predicted that globalization would bring with it an increase in inequality in the advanced developed countries, but a decrease in inequality in the developing world, as wages of unskilled workers get bid up. In practice, however, globalization has been accompanied by an increase in inequality in both developed and less developed countries. This is probably partly because the very poor—subsistence workers—are being left behind; but it is partly because globalization has been asymmetric, with liberalization of capital increasing at a pace faster than liberalization of labor, leading to asymmetric changes in bargaining positions. A related asymmetry that has also contributed to increasing inequality within developing countries is that the liberalization of trade in goods and services has favored those items in which the rich countries have an advantage as compared with the labor-intensive goods and services that would benefit the poorer countries; and in spite of all the free market rhetoric, the advanced industrial countries continue with huge subsidies to agriculture, which lowers the incomes of those in the rural sector, who typically (as in China) have incomes far less than those in the urban sector.

More generally, there are strong reasons to believe that the extremes of inequality observed in some of the advanced industrial countries—an inequality which has grown markedly in the past 15 years—has little to do with the normal workings of the competitive market place, but in fact reflects a set of *market failures,* exemplified by the abuses so evident in the scandals that marked the 90s, but which continue to today;[8] as well as regressive tax and expenditure policies with tax cuts or bail outs for the rich being paid for in substantial measure by a rollback of the social safety net. It is important that as China moves to *its* form of a market economy that it guard itself against this possibility—which would result in a *less* efficient economy and a *less* harmonious society.

A New Innovation System

China has recognized that what separates less developed from more developed countries is not only a gap in resources, but a gap in knowledge as well, and has laid out ambitious plans not only for reducing that gap but for creating a basis for independent innovation.

A country's innovation system consists of several parts: (a) A strong educational system, beginning with strong scientific and technology training at the elementary and secondary level, but culminating in strong universities, with world class graduate programs. (b) Strong support for basic research, conducted within research universities and independent research institutes. (c) Policies, programs, and institutions which facilitate knowledge development and transfer within the corporate sector. (d) A balanced intellectual property regime. (e) Sources of finance. (f) Policies designed to reduce the risks of innovation or the consequences of failure.[9] Success entails strength in all, and close interlinkages. China's attempt to create first class universities and research institutes is

[8] I provided an economic analysis of these in my book *Roaring Nineties,* W.W. Norton, 2003. (available in Chinese)

[9] In that sense, even a country's safety net can be thought as part of its innovation system: it reduces the downside risk of failure. Some argue that the strong safety nets in the Scandinavian countries are part of the reason for those countries' high level of innovation.

an important component in these efforts, but there are other aspects which may not have received the attention they deserve. There are two, in particular, on which I wish to comment.

In some ways, TRIPs and WTO accession, for all of its benefits, has made it more difficult to close the knowledge gap. Some commentators, with some justification, refer to the advanced industrial countries as "kicking away the ladder": having achieved what they have through a variety of industrial policies (including protection and subsidies), they now seek to preclude developing countries from following in their footsteps. Nonetheless, there are a variety of ways in which government can help particular sectors. Government is allowed to support basic research, and there are clear spillovers from basic into applied research. Europe, again quite rightly in my judgment, has accused the United States of using defense expenditures as hidden industrial policy. While support for R & D in aeronautics has been the focus of attention, there are other areas of civilian benefits of defense expenditures (which, the Department of Defense, in speaking to other constituencies, almost boasts about): DARPA, a division of the Defense Department, helped create the Internet and financed the prototype of the browser. Access to credit can be important, and the government can create financial institutions to provide credit (even if that credit is provided at standard rates.). [10]

The intellectual property regime within TRIPs is not a balanced intellectual property regime; there are enormous societal costs associated with intellectual property—it creates a monopoly power, which raises prices and creates significant market distortions. These societal costs can be particularly grave when they build on already existing monopoly power and when they touch vital areas—as is the case for life-saving medicines. In both cases, standard practices in the advanced developed countries (and the WTO) allow intellectual property rights to be circumscribed; compulsory licenses can be used, and abusive market practices can be enjoined. Such abuses are likely to be particularly acute in developing countries (like China).

The large costs that can be associated with intellectual property rights are justified only if the benefits in terms of induced innovation are large enough. The problem is that excessively strong or unbalanced intellectual property protection can actually slow down the pace of innovation. The most important input into research is ideas, and patents may reduce the availability of ideas. Patent thickets have also presented a barrier to innovation. Microsoft has shown how excessive monopoly power can stifle innovation, as innovators like Netscape and Realnetworks see their creative contributions squashed by a dominant firm. The *World Development Report* for 1998, on *Knowledge for Development* expressed the concern that a lack of balanced intellectual property rights would be especially bad for developing countries.

[10] Another policy to encourage innovation is that pursued in some East Asian countries whereby the government purchased machines embodying new technologies and lent them to the private sector to try out for a period at the end of which they had to either buy the machines or return them. Whether current WTO rules permit this form of reducing risks of innovation needs to be ascertained.

It is, accordingly, imperative that, within the framework of TRIPs and the WTO, China strives to achieve as balanced an intellectual property regime as possible, and that it makes full use of the flexibilities embedded in TRIPs, including those associated with the issuance of compulsory licenses.

In certain areas, like health care research, the patent system has shown itself to be an especially expensive, inefficient, and inequitable way for financing research. There are alternatives that need to be considered. One under discussion in the United States (there is actually a bill in the U.S. Congress) calls for the creation of a Medical Research Prize Fund, which would award prizes to medical researchers on the basis of the significance of their contribution. Me-too innovations would receive little reward; a drug that addressed a major medical problem like malaria could receive a large award. The patent would then be held by the government, and the drug would be made available (say at marginal cost). This system can provide strong incentives for research, directed at ways that contribute to society, *without* imposing the huge costs of the current system.

There is an important lesson in this: As China marches towards a market economy, it should be careful not to imitate those parts of the market economy which are badly flawed; at the very least, it should inform itself about the flaws, discuss how they can be addressed, and look for alternatives.

The environment and natural resources

China's growing population and growing demands on resources will, inevitably, put enormous strains on the environment, both within China, and globally. China's 11th five-year plan seems to have taken this message to heart; one could only wish that all other countries have a corresponding commitment to preserving the environment for future generations. It will, of course, be important to implement these ambitious social commitments, and I shall have a word to say about this later. There are, however, four further points that I wish to make.

First, an increasing fraction of China's population will be living in cities, and while it appropriate that, given the imbalance in well-being between the urban and rural sector, attention is focused on the rural sector, still, *making cities more livable* should not be neglected; without an appropriate emphasis on making cities livable, an increasing fraction of China's population may live in locales where the air is polluted, suffering from excessive congestion, and without adequate parks, recreational places, and other public facilities.

Secondly, environmental taxes (carbon taxes, recycling taxes, taxes on the use of commodities) serve double duty: they raise needed revenue while encouraging better use of the environment. As China moves to the market, it should employ more market mechanisms in addressing societal needs.[11]

[11] Moreover, such taxes may encourage innovations on how to economize on these natural resources.

Thirdly, China's avaricious appetite for natural resources, like timber, can have strongly negative effects on other countries. It can lead to deforestation of slow growing hardwood forests, without appropriate efforts at replanting. But in the rest of the world,, China has shown less concern about such deforestation. It should join the growing demand for certified lumber. In other countries, the demand for natural resources has led to conflict; and the control of natural resources has enabled some authoritarian governments to engage in abuses against their peoples, even to the extreme of genocide. China should be an active participant in an attempt to control these problems, joining in boycotts against Sudan for genocide or against the conflict diamonds from Sierra Leone.

Finally, China should not give the lobbies in the U.S. more concerned with short-term private profits than the well being of the planet an excuse: They claim that without China, efforts to do anything about global warming are fruitless. This, to them, provides a justification for America not joining the Kyoto protocol, and maintaining its policy of energy profligacy. The scientific evidence on the threat of global warming and the link with greenhouse gas emissions is overwhelming—and the consequences are becoming apparent at a startling rate. That is why China's commitment in this Plan to increasing efficiency, e.g. in lowering emissions per dollar of GDP is particularly commendable. But China should do more. Last year at this forum, I spoke of China's new role of global leadership. Among the important areas where that leadership needs to be exercised is helping the developing countries develop a common constructive position on global warming. They should, for instance, support the initiative of the Rainforest Countries to embrace avoided deforestation within an expanded Kyoto Protocol. This will provide developing countries whose forests play such an important role not only in avoiding global warming but also in preserving bio-diversity both incentives and funds with which simultaneously to pursue sound environmental policies and aggressive growth policies.

China's relationship with the rest of the world

China's increasing economic size makes it inevitable and necessary for its role to change. Last year in this forum I discussed China's role in the global economy I spoke, for instance, of the increasing role it should be playing in trying to help create fair global rules, e.g. within the WTO, and in providing role models, and even assistance, for developing countries. In this context, I would like to commend China's recent efforts to encourage trade with African countries, particularly by increasing its imports from Africa.

It has become increasingly recognized that China will have to depend more on the growth of domestic demand, and less on exports to sustain its economy.

While American politicians blame China for America's huge trade deficit, as it borrows more than $2 billion a day, economists all over the world recognize that trade deficits represent macro-economic imbalances, an excess of domestic investment over domestic savings, and that America's huge trade deficit today largely reflects its paltry domestic savings, its negative household savings (the first time since the Great Depression), and its huge fiscal deficit. Nothing that China does, at least with respect to its exchange rate, will affect, in a significant way, America's domestic investment or savings; and hence nothing that it does will affect its trade deficit. As unjustified as claims that China is engaged in unfair trade policies may be, the *real politick*, however, is that China will continue to come under pressure[12], and it is wise for China to shift towards more reliance on domestic demand.

China has been engaged in what might be called vendor finance—it has been providing manufactured goods to the United States, and at the same time, making hundreds of billions of dollars of loans to the United States at low interest rates to finance the purchases. If China can provide vendor finance to America, to sustain a tax cut for the richest people in the richest country of the world, does it not make even more sense for China to provide vendor finance to finance the consumption of its own people, or investment that the country needs to sustain its own growth? Of course, it is imperative, if this is done, that the investment projects be carefully chosen, that the funds for purchases of housing or consumer durables are provided at levels commensurate with individuals' ability to repay, and that there is a legal framework and a credit culture that ensures that money lent is repaid.

Finance is only one of the factors holding back domestic consumption. As China has moved to a market economy, the social safety net has been weakened, sometimes at a faster pace than the market safety net has been put into place. Linking closely the provision of social services with enterprises is a mistake—it has brought problems even in the United States, e.g. in the automobile industry. At the same time, the erosion of health and education services in the rural sector not only has adverse effects on the well-being of those living there, reflected in the social indicators referred to earlier, but also increases the need for savings. Households have to put aside money to pay for future education expenses of their children and to meet unexpected health care needs. Restoring a strong public health care system throughout the country, and especially in the rural sector, would reduce the need for precautionary savings. Creating a strong national social security system would reduce the need for precautionary savings for retirement. Creating a strong national unemployment insurance system too would reduce the need for precautionary savings to meet these needs.

Clearly, what is required is a balance. In the West, there is a worry that excessively strong and poorly designed public safety nets has contributed to undermining savings and weakened incentives. But China may have, now, gone too far in the other direction. There are a number of ways in which that balanced regime may be attained. Singapore's

[12] It will, in particular, come under pressure both to appreciate its exchange rate and to make its exchange rate more flexible. There is often a confusion between allowing "more flexibility" and "capital market liberalization." The latter has proved particularly problematic, and China has been well served to avoid the extremes. Again, as discussed in the China Development Forum last year, there are large costs associated with the high volatility of exchange rates, especially in regimes with liberalized capital accounts. Currency appreciation too has a large costs, especially in potentially lowering incomes of those in the rural sector (a subject of particular concern in the 11th five-year plan), and in slowing down growth in export oriented sectors (which may be of particular relevance in the promotion of innovation and technology.) We argued last year for the advantages of an export tax, which has similar effects on the trade surplus, but has the further advantage of generating revenue while avoiding the adverse effects on the rural sector.

Provident Fund provides integrated individual accounts where funds can be used to address a variety of needs. (Elsewhere, I have argued that such integrated accounts are far preferable to the separate accounts, one for retirement, one for health, etc. more commonly employed.) In high income, urban areas, there will be a role for the continued development of supplementary insurance markets (but these will require tight supervision, if the problems that have often arisen in these markets are to be avoided.)

China's problem in trying to encourage domestic consumption is the envy of the rest of the world. It provides a further argument for policies, like strengthening social safety nets, that should have been high on its agenda in any case: such safety nets are an essential ingredient of a harmonious and efficient society.

China should take advantage of its unique position while it can. For instance, there are great advantages of having a value added tax that covers all commodities (that does not provide an exception for investment); not only is administration simplified, but it generates greater revenue (alternatively, the same revenue can be generated with lower rates.) Additional public revenue is of enormous value at China's current stage of development. Typically, in the West, countries are encouraged to have a consumption based V.A.T., because governments are trying to discourage consumption and encourage investment. But that is not the problem of China. (More generally though, China should be discouraged from excessive reliance on the V.A.T., because it is a regressive tax; given China's enormous increase in inequality, referred to earlier, it is important for it to introduce progressive income taxes and higher taxes on commodities that are consumed by higher income individuals.[13])

China's problem of "excessive savings" could quickly disappear, and it should be ready to adjust its policies if that occurs; and the policies and programs that it institutes today should be designed with enough flexibility that they can be adjusted to meet the evolving needs of the economy, if these changes in circumstances do occur.

Institutional reform

China's 11th five-year plan recognizes that one of the main responsibilities of government is to establish the institutional infrastructure required to make a market economy function well. Elsewhere in the world, we have seen deficiencies in the institutional infrastructure result in scandals, touching on almost every major accounting firm, large fractions of the major investment banks, and many of the major corporations. America's economy was strong enough to withstand the enormous misallocation of resources that resulted; China's may not be; at the very least, the costs would be far greater. The scandals left many without adequate provision for their retirement, while the bubble to which they

[13] The United States during the Clinton Administration discussed the possibility of introducing the V.A.T., and dismissed it, because of its regressivity. In most developing countries, it is also not an efficient tax, because there are large parts of the economy from which it is not collected. See, for instance, S. Emran and J. E. Stiglitz, "On Selective Indirect Tax Reform in Developing Countries" *Journal of Public Economics*, April 2005, pp. 599-623

contributed, contributed in turn to the growing inequality within America. It was not a question of a few rotten apples: the problems were clearly systemic.

It is even more important for China to have strong and flexible laws that deal with the problems of corporate governance. America's SEC and Britain's Financial Regulatory Agency provide role models, but they do not go far enough. New York State's Martin Act (General Business Law) and the Executive Law are examples of forward looking legislation which can play an important role (when combined with active enforcement) in creating the environment of the kind necessary for capital markets to function. It will never be possible *ex ante* to specify all of the ways in which businesses may engage in misdeeds , defrauding shareholders or their customers. But it must be possible to enjoin such practices as soon as they become evident, and to punish the corporations and their officials who have been involved in the perpetration of these economic crimes. This is what the Martin Act and the Executive Law do.

A market economy only delivers the benefits which are promised if there is strong competition. But profits can often be increased most easily by creating a monopoly or weakening competition through the creation of barriers to entry. That is why it is important to have an active and vigilant anti-trust authority. Many anti-competitive practices occur at the local level, and it may therefore be important to create such authorities not only at the national level, but at the local level.

An important aspect of institutional design focuses on *duplication* and *risks of mistakes.* In the United States, anti-trust oversight resides in the anti-trust division of the Justice Department, the Fair Trade Commission and state anti-trust authorities. In addition, those injured by anti-competitive behavior can take civil actions with triple damages. (In the area of telecommunications, further oversight is provided by the Federal Communications Commission.) Similarly, there is multiple oversight in banking and securities regulation. There is a cost—but the benefits are far greater. The risk –the costs to the economy—from institutional failure is enormous. This is particularly of concern in those areas where political influence (including regulatory capture) is likely to occur—clearly areas of concern for both financial market regulation and anti-trust.

Implementation

This brings me to what I view as a key issue in the implementation of policy. China is a huge country, and pronouncements of policy in Beijing often have to be translated into actions at the local level. The balance of interests and concerns that play out at the national level may play out differently at the local and provincial levels. The environmental issues facing the country may be apparent at the national level; but the need to create jobs may seem more paramount at the local.

In the continual evolution of China's economy and society, mechanisms for implementing the national plan and for inducing the achievement of national goals inevitably will change. There may need to be greater reliance on incentives, of the kind that are commonly employed in federal systems, e.g. where national authorities provide financial incentives, both rewards and punishment, for compliance. Still, of course, the most important instrument will be to develop a national consensus behind the goals and objectives of the Plan, something which the widespread discussion of the Plan is intended to do.

Ideology and interests

But as China goes forward with its transition into a market economy, it will increasingly confront a problem which has confronted market economies elsewhere in the world: the conjoined influence of free market ideology and interests to shape a market economy that is *not* in the broader interests of society.

As enterprises grow in influence and wealth, they will try to use political processes to garner more for themselves. They will use arguments for why what they want for themselves is in fact good for the country. Companies talk about the loss of jobs, and threaten that they will move elsewhere or reduce their employment if government does not do what they want. They use these arguments to weaken environmental standards and work safety protections. And because there is not widespread understanding of economics, such self-serving arguments often prevail, or at least provide sufficient cover for actions which are counter to the general interest.

If one looks at the tax code of the United States, you will see it riddled with provisions that make no economic sense; they are there because of the influence of special interests. The United States is contributing enormously to greenhouse gas emissions, leading to global warming; its energy profligacy has made America dependent on foreign oil. There are countries with just as high a standard of living that are using half as much energy per capita as the United States. A carbon tax (or an energy tax) would actually increase overall efficiency—it makes sense to tax things where there is a negative externality (like pollution) more, to substitute such taxes for taxes on workers (who have been doing so poorly). But America's energy industry has used its political influence to keep energy taxes low. Similarly, America's huge farm subsidies--$3 to $4 billion to 25,000 rich cotton farmers—are bad for the environment, costly to taxpayers, and impose enormous costs on developing countries as they lower global prices, further impoverishing some 10 million farmers in Africa alone. These policies do not represent good economics, nor are they consistent with any sense of social values or priorities. But they are the consequence of the workings of special interests.

China, as it moves towards a market economy, needs to be on guard against the role of these special interests. Already, some have suggested that such influences are in evidence in the continuing low price of energy. If China succeeds in creating a market economy in which these have at the most very limited sway, China will truly have created a market economy with Chinese characteristics.

I began these remarks by some observations on Adam Smith's invisible hand, the belief that the best way to achieve economic efficiency is unfettered markets. Understanding the circumstances under which that might be true has been the most important quest in economic science over the past two and a quarter centuries, and the success in analyzing systems of the complexity of the modern economy should be viewed as one of the greatest achievements. Like any such achievement in science, it is the result of the cumulative efforts of scholars and researchers, though inevitably, a few receive recognition for their contributions. Arrow and Debreu showed, for instance, in the mid-50s that free and unfettered markets led to economic efficiency only under highly restrictive conditions, and their proofs of the efficiency of markets provided insights into why markets so often failed. Work in subsequent decades attempted to show that there were other conditions, not identified by Arrow and Debreu, in which markets might be efficient. But by now, through the work of a host of scholars (to which my own work on asymmetric and imperfect information and incomplete markets contributed) as well as a host of historical experiences, we know the problems of unfettered markets, and we know that every successful economy has been based on an appropriate balance of the market and government. As I noted earlier, governments play an especially important role in innovation, in providing safety nets, and in maintaining a "harmonious" society, one in which the ethics of social justice and social solidarity are in evidence.

In the coming years, China will be facing some of its most important decisions as it moves to the market economy, for it will increasingly be establishing the rules of the game, the institutions that will not only guide it as it makes its next steps, but will serve to "govern" the market economy. The debate over these rules will be contentious. There will be those that come forward with self-serving arguments for why it is best to minimize regulations, or to have no regulations. And they will come armed with stories illustrating the dangers of excessive regulation. I cannot, in the short space here, engage directly in each of these debates. But I want to end with two strong assertions: *There is no theoretical basis for the contention that unfettered markets lead to economic efficiency*. The rejection of that contention has been one of the great achievements of economic science during the past half century. *Every successful market economy has been based on achieving an appropriate balance between the market and government.*[14]

Concluding Comments

Many years ago, China set forth on its course of "crossing the river by feeling the stones." It has moved far across the river, and it has felt many stones. It has achieved enormous successes, and yet it faces enormous challenges. China is still a low income country. In spite of its remarkable successes, even in purchasing power parity, per capita income is only an eighth of that of the United States. The 11th five-year plan combines a comprehensive and pragmatic blueprint with a vision: a guide to the country as it takes its next steps in crossing the river. In doing so China needs to avoid the pitfalls and embrace the promises that I alluded to. That will require clarity of vision and values about the kind of market economy that China wants. Its past success in balancing vision with pragmatic flexibility and its increasing attention to "social harmony" augurs well for the 11th five-year plan and beyond.

[14] To be sure, countries have survived short periods in which that balance has been lost; but as that balance gets lost, and the consequences become evident, corrections are set in motion.