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## Foreword

Zhou Ye-an, Ke Rongzhu and Zhang Bin

### China Economics in 2010 and This Book

Although theoretical research is supposed to be the main focus of economists, as social and economic problems become increasingly prominent, more and more Chinese researchers are willing to devote energies to the studies of economic policies. There are two main issues in the current Chinese economy: First, the stability and sustainability of economic growth; second, the growing inequality and other related public issues. Most recent studies contribute to our understanding on these two issues. Among the published papers in 2010, there are abundant papers investigating the fluctuation of macro economy, economic growth and related macroeconomic policies. However, high-quality papers are rare. There is a lack of basic theoretical investigations, in contrast to the research frontier overseas. Most researchers seem to be more interested in the evaluation and analysis of short-term macro-economic policies, rather than trying to establish unique logics and models that are specific for the China economy. As a consequence, even though researchers have been applying different fancy theoretical models to China's macroeconomic problems, they could

hardly reach the essence of issues, which is a bottleneck for China's macro-economic research.

Public issues like inequality in income distribution, environment and resources, and public health etc. are focal points in recent years, which have attracted a lot of attention from researchers. In particular, as micro-econometrics becomes a popular tool for young researchers, the study of public issues has switched focus to the exploration of the logical relationship between variables and relevant scientific evidence. The growing number of young scholars is an engine for the development of Chinese economics. They have obvious advantages in employing methods and tools in research. This advantage, once combined with the experience of elderly scholars effectively, will greatly facilitate the progress of the Chinese economics. Take research on public issues for example. High-quality papers have been emerging. We had a special section called income distribution for the 2009 version of this book series, which collects six papers representing the research status of the field at that time(see *China Economics—2009*). When editing this 2010 version, we are happy to find that the research on public issues is still excellent, and a number of articles in this field are recommended. Therefore, we decide to again make a special section—research on public issues and related policies, in order to highlight the efforts and accomplishments of researchers in these areas.

Meanwhile, there are still many researchers trying to explore some basic theoretical issues, which may be difficult to

attract attention, but is the most important driving force for the progress of economics in China. The number of this type of studies is small, but they represent the academic pursuance of China's economic researchers. Three outstanding articles are chosen. The first paper, by Wu Yaowu, discusses weak instrumental variables. In general, domestic researchers tend to employ micro-econometric methods directly to study China's economic problems, without further discussion of methodological issues. Based on Chinese data, and starting from estimating the returns to education, Wu's paper discusses whether or not birth quarter is a weak instrumental variable, which not only is a bold attempt, but also provides a benchmark for later researches. The paper by Li Jinbo, Nie Huihua and Shen Ji, proves the existence of the collective reputation rent can alleviate the moral hazard problem in team production, using an interesting contract-theoretic model. This is a pure theory paper, the idea and the modelling techniques of which are both impressive. If more young scholars make comparable contributions, China's economics will be more promising. The last paper, by Guan Hanhui and Li Daokui, is related to economic history. They estimate the GDP and its structure of the Ming Dynasty. Domestic historical research typically takes the form of narration and documentation, and there are few quantitative analyses that interpret the logical relationship between historical events. Fortunately, a few scholars have started to fill in this gap in recent years. For example, Liu Ti estimated the GDP of the Ming and Qing Dynasties in some recent papers

and books. Guan Hanhui and Li Daokui employ more sophisticated methods to estimate the total GDP and its structure of the Ming Dynasty. These studies make a big step forward for the research of China's economic history, and the related research can no longer rely on Madison's estimates only.

Overall, China's economic research in 2010 was very fruitful. The relevant academic journals supported our editing as usual. The total number of recommended papers is 51. We finally select 14 papers for *China Economics—2010*. Some excellent papers are not selected for four reasons. First, for one author, at most one paper can be selected; second, our own(the editors') papers are not considered; third, literature survey papers are not considered; fourth, papers with important shortcomings are not taken into account either. As before, we should claim that the selected papers are not necessarily better than those that are not chosen. This book could not fully represent China's economics. Yet we hope to showcase the progress of the China's economics from some aspects.

## **An Overview of Selected Papers in this Series**

### **The Topics of Public Issues and Related Policies**

We categorize papers by research topics. Seven papers on public issues and related policies are edited into one section. These papers not only study particular public issues, such as the demand for tobacco and tobacco taxes, energy and income distribution, but also discuss about research methods com-



bined with public issues. The papers demonstrate high academic standards. We need to emphasize that these papers have paid attention to the estimation of important parameters using scientific methods, and the provision of solid evidence for future discussion and public policymaking. Previous research on public issues have three disadvantages; first, neglecting evidence in the debate of different ideas, one of the consequences of which is that the policy suggestions are always empty and impractical; second, small sample estimation resulting in implausible policy implications; third, applying foreign methods or conclusions in a simple way without adapting them to the Chinese contexts. Fortunately, some scholars have now begun to do careful and scientific research and try to estimate the nature and extent of the relationship between some important variables, so as to provide a good platform for future debate on these issues.

Gao et al. (2010) is one of the representative papers. Based on panel data from the China Health and Nutrition Survey (CHNS), this paper estimates the demand for tobacco of Chinese residents and in particular estimates price elasticity of demand of tobacco using traditional demand model, short-sighted addiction model and rational addiction model. Based on this estimation, the authors further discuss the impact of tobacco taxes. Of course, this study has some shortcomings. For instance, the authors point out that this study does not use more reasonable 2SLS estimation. Zheng Xinye also comments on the article: The division of income levels in this

paper is simple; the paper does not clearly distinguish price changes between different varieties of cigarettes; the theoretical assumptions are not clear and so on. We would like to emphasize that this is an outstanding paper that presents comprehensive estimates of China's domestic consumer price elasticity of demand. The discussion of China's economic issues in the past was most dependent on estimates of a variety of parameters by researches abroad, making the theoretical and policy discussions unable to get the essence of issues. The paper of Gao et al. is an attempt to fill in the gap. Although their methods and conclusions remain to be imperfect, there is much that researchers can learn from their efforts.

The following three papers all discuss income distribution, among which Fan and Zhang(2010) emphasizes on the aspect of fiscal transfer payments. The so called "using concentrated resources to do magnificent things" is usually considered an advantage of the centralized decision-making system over the decentralized mechanism. Nonetheless, Fan and Zhang(2010) offers a counter example to this. They find that the large-scale transfer payments by the central government, regardless in the form of fiscal subsidies or specific project investment, could be beneficial for the local economy only in the short run; while in the long run, the effect is negative, even measured by the simplest indicators of GDP and its growth. Applying panel data, they discover that the positive impact of transfer payments on local economies is largest in the second year, and decreases afterwards and becomes negative in

the seventh year, with the largest negative effect in the 12th year, and then disappears gradually. This result is very surprising. If the recipients can even not really benefit in terms of economic and social development, taking into account incentive losses and other costs incurred to the paying parties, “using concentrated resources to do magnificent things” is virtually a loss-loss decision. This paper provides a valuable reference for policy-making. Nevertheless, the robustness of the estimates should be carefully checked. With data of only 11 years, the reliability of the inference out of the 11 year data needs further examination. Moreover, though discussed in the paper, the source of the inefficiency resulted from the fiscal transfers remains unclear.

Xing(2010) focuses on the possible impacts of inter-regional labor mobility on income distribution. Migration is not only an important decision for individuals and their families, but also plays a very important role in social reallocation of human resource. This decision will have significant economic consequences on both individuals and the society as a whole, in which the income inequality performs a pivotal role. However, it is not easy to estimate the impact of migration on income accurately, which is due to the endogenous selection problem. Because of the inherently different characteristics between migrants and non-migrants, the advantages of migration may not result from the decisions themselves. Using micro-level data, this paper separates the effects of migration from those of self-selection to estimate the impact of migration on income. The

prominent part lies in the estimation of the counterfactual income distribution. A counterfactual inference attempts to find the hypothetical fact which never occurs, that is, what would be like at present if something that actually occurred has never taken place. By using two datasets with possible biases in opposite directions to mitigate biases, the author estimates the counterfactual distribution with advanced econometric methods.

The estimation demonstrates that the migrants who obtained *Hukou* (household registration) would gain higher income even if they did not migrate to cities. In contrast, income for the workers from rural areas remains at the left tail of the income distribution even after their migration. The self-selection effect of urban immigrants with *Hukou* is more salient in the early stages of the reform. According to this estimate, migration seems to have reduced income inequality within rural areas, leading to efficiency improvement. On the other hand, migration has increased the degree of inequality between urban and rural areas. Utilizing the same datasets and methodology, researchers can investigate several other interesting topics in the future. For instance, does migration influence the allocative efficiency of human resources? Without the immigrants, will the labor participation rate in cities change? Does the higher income of urban immigrants come from the improvement of the welfare system or the increase of labor productivity? Can the ratio of the two be quantified? We look forward to more excellent studies.

Shao and Huang(2010) is concerned about the impact of

foreign direct investment (FDI) on income distribution. In recent twenty years, the continuing decline of the share of labor compensation in GDP has been attracting great attention. In *China Economics—2009*, Bai and Qian's paper (*Social Sciences in China* 2009) that investigates this issue is included. The research by Shao and Huang (2010) provides a novel rationale to explain the continuing decrease. The paper finds that, in the industrial sector, FDI has a considerable explanatory power in explaining the decreased share of labor compensation, which is approximately 30% to 40%. The authors believe that this negative impact mainly comes from the negative "wage spillover" effects. Foreign enterprises pay higher wages to attract talents with higher labor productivity, and reduce their mobility. Consequently, the rest of the companies can only employ workers with relatively lower productivity, with lower wages being paid. Using a comparison of different models, the authors treat this endogeneity problem very carefully, with the support of a tremendous amount of literature illustrating the possible impacts of FDI on income.

If the results are reliable, the paper provides valuable reference to assess the pros and cons of foreign investment. However, there are two questions worth further analysis with respect to the negative wage spillover effect. First, what is the underlying mechanism of the negative wage spillover effect? In foreign invested enterprises, why does the high wage lead to a lower proportion of labor income share? The reason should be due to that the profit margin is higher in such companies. Fur-

ther more, why can foreign enterprises attract high quality talents to create high profit margin while the domestic companies can not? Why domestic firms can not imitate such “high investment-high profit” model employed in the foreign counterparts? Are human resources exploited to a larger extent in foreign companies than in domestic firms? If the difference of productivity-wage ratios in foreign and domestic enterprises is verified, clearer patterns can be revealed. Second, the causal relationship may be reverse. It could be the case that foreign investment takes the advantage of cheap labor in China, rather than that the decline of income share follows the introduction of foreign capital. In this situation, it is necessary to pay attention to the sustainability of cheap labor supply. Under a mercantilist-oriented policy, the host country should be cautious about the risk of becoming a paradise with super-national treatments for foreign investors, lacking bargaining from labor unions and rigorous social securities.

Carbon emission is undoubtedly an important public issue. Effective protection of the environment requires efforts from individuals, families, the state, and nations. The climate problem involves the division of responsibilities of carbon emissions. Fan et al. (2010) tries to establish an analytical framework to measure the responsibilities of carbon emissions from ultimate consumption. They first calculate the cumulative consumption emissions of each country between 1950—2005, and find that the consumption of other countries contribute significantly to China’s actual carbon emissions;

Second, they further calculate cumulative per capita consumption emissions of each country between 1850—2005, and find that the primary responsible parties for carbon emissions are developed countries. They propose a principle called common but differentiated carbon consumption rights, which takes into account both total and per capita carbon emissions. To briefly evaluate this paper, the issues discussed are important, and the conclusions are meaningful, but the disadvantages are also obvious. As Feng Junxin comments, the paper divides the economy into homogeneous consumption good sector and investment good sector, which is too simplified; moreover the calculation ignores sedimentary carbon emissions during capital accumulation, and assumes two extreme scenarios as the upper and lower limits of cumulative consumption emissions, making the calculation results not accurate.

China's public issues are largely related with the local government behavior. Existing research basically agrees that competition between local governments and the expenditure bias lead to issues such as insufficient supply and structural distortion of public goods, etc.. Zhou Li-an et al. (2004, 2005, 2007) try to explain these phenomena using a tournament theory, the core of which is that the evaluation system for governmental officials is GDP-oriented and relative performance of local economy is directly related to the officials promotion. This "officials promotion tournament theory", which is cited and expanded by a large number of researchers, has become one of the mainstream theories to explain China's

economic development models and results. But scientific research should dare to doubt popular theories. Tao Ran et al. (2010) is the representative. Based on the paper of Zhou Li-an et al. , this paper makes three modifications: First, redefine the promotion, demotion and transfer of governmental officials in China's political hierarchy; second, supplement and update the data; and third, amend the period of data. This paper finds that the tournament hypothesis is rejected, i. e. there is not statistically significant and robustly positive correlation between political promotion and economic growth or economic performance. The conclusion seems be consistent with the facts of government officials' promotion in China. Since the division of work is different and the assessment is comprehensive, we can hardly conclude that GDP is the only factor to judge an official's capability. Some scholars have questioned the tournament hypothesis in recent years. However, the paper by Tao Ran et al. is worth more discussions. For example, apparently how to define the variables can greatly affect the regression results, as pointed out by Hong Fuhai and Zhao Wenzhe. Therefore the paper needs to test the result robustness.

Public policy research relies on micro-econometrics method, in which the endogeneity problems are often encountered and need to be attacked. The instrumental variable(IV) is a commonly used method. However, what kind of variables should be used as an IV? Is the IV strong or weak? Discussion on these issues directly affects the estimation results and policy



implications. Wu (2010) tries to take into account these issues, which are often ignored in the literature. Birth quarter is usually used as a weak instrumental variable in estimating returns to education. However, this approach is often applied to data in developed countries, which may not be suitable for developing countries like China. Therefore, we need to reevaluate the result. Using 1% sample survey data of China's population in 2005, the authors re-estimate the model and find that birth quarter is not a weak instrumental variable. Existing research use birth quarter as the weak instrumental variable without noticing the model setup and data quality. Therefore, the author clearly states that data quality is a key factor for empirical analysis and economists who conduct empirical analyses should be concerned about this issue. We believe that this paper and the above view are worth serious consideration of domestic academic circle.

### **The Topics of Microeconomics and Development Economics**

Microeconomics has been one of the concentrated research fields among domestic scholars. However, there are few papers engaged in the fundamental analysis, which could be attributed to the inadequate theoretical training of majority of the domestic scholars. It is praiseworthy that more and more young talented scholars are involved in such researches, among which Li Jinbo, Nie Huihua and Shen Ji have presented an excellent paper entitled "Team Production, Collective Reputation and Sharing Rule". They introduce a reputation mecha-