



## Entrepreneurial talent and economic development in China

Weiyang Zhang<sup>a</sup>, W.W. Cooper<sup>b,\*</sup>, Honghui Deng<sup>c</sup>, Barnett R. Parker<sup>d</sup>, Timothy W. Ruefli<sup>b</sup>

<sup>a</sup>Guanghua School of Management, Peking University, Beijing 100871, China

<sup>b</sup>The Red McCombs School of Business and Fellow, IC2 Institute, University of Texas at Austin, Austin, TX 78712-1174, USA

<sup>c</sup>College of Business, University of Nevada Las Vegas, 4505 Maryland Parkway, Las Vegas, NV 89154-6034, USA

<sup>d</sup>Graduate School of Business, Department of Health Administration, Pfeiffer University, Charlotte, NC 28209, USA

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### ABSTRACT

In this paper, we argue that the economic miracle of China in the past three decades can be attributed to the reallocation of entrepreneurial talent from the government/state and agricultural sectors to business activities. This change is unprecedented in the past two thousand years of Chinese history. When entrepreneurial talent was moved more to business activities, it created wealth, and the economy boomed. Three dominant groups of entrepreneurs are identified: (1) Peasants-turned entrepreneurs, (2) officials-turned entrepreneurs, and (3) overseas-returned, and engineers-turned, entrepreneurs. They have emerged sequentially, and successively led three decades of economic growth. The success of the Chinese economy arises from a gradual replacement of position-based rights with property-based rights that has triggered this reallocation of entrepreneurial talent. We also argue that when position-based and property-based rights coexist, value-creating and rent-seeking can be complementary. Therefore, one should not be puzzled by the coexistence of rapid economic growth and pervasive corruption in China. In order to improve the *efficiency* of allocation of entrepreneurial talent and efforts, it is important to further reduce the domain of position-based rights, and build a better-defined and more effectively-protected property rights system.

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### 1. Introduction

When China began its economic transition, it was unimaginable that an 'economic miracle' would occur within a period as short as thirty years. Indeed, when Deng Xiaoping set the target that, by the year 2000, China's total national income would quadruple that of 1980, many people, including government officials and economists, thought that Deng was being too ambitious, if not unrealistic. However, development of the Chinese economy has been even more rapid than Deng's forecast. In the past three decades, China's per capita GDP doubled in less than every 10 years, reaching US\$ 2500 by 2007. China rose to be the fourth largest economy in the world by 2005, from 10th in 1978, and the third largest international trade country by 2004, from 27th in 1978.<sup>1</sup>

In 2006, China surpassed Japan and became the largest foreign currency holder and, while in 2007, five of the 10 largest companies listed in terms of market value were from China. On a related note,

debate about the Chinese currency's exchange rate has become an international political and economic issue.

Many outside observers have queried: How could the Chinese economy have been so successful, given that large percentages of key resources are under government control, while property rights are vaguely defined? Importantly, the rapid economic development of China has resulted from a gradual introduction of markets, and the replacement of position-based rights with property-based rights (to be defined in detail, below). History has shown that the market mechanism is the best engine for economic growth, and can create economic miracles like China. In fact, there is no fundamental difference from examples of similar economic developments in Western-developed countries, such as Great Britain during the industrial revolution, and the United States in the late nineteenth and early twentieth centuries, as well as some East Asian countries such as Japan and South Korea after the Second World War. Once market forces are introduced, and appropriate incentives are in place for people to pursue wealth, growth surely follows, sooner or later. We thus suggest that the best way to understand China's economic development is to understand how markets operate.

What is a market economy? A widely-accepted, yet simple definition is that *a market economy is equal to freely established*

\* Corresponding author.

E-mail addresses: [wyzhang@gsm.pku.edu.cn](mailto:wyzhang@gsm.pku.edu.cn) (W. Zhang), [cooperw@mail.utexas.edu](mailto:cooperw@mail.utexas.edu) (W.W. Cooper), [honghui.deng@unlv.edu](mailto:honghui.deng@unlv.edu) (H. Deng), [barnett.parker@fsmail.pfeiffer.edu](mailto:barnett.parker@fsmail.pfeiffer.edu) (B.R. Parker), [tim.ruefli@mcombs.utexas.edu](mailto:tim.ruefli@mcombs.utexas.edu) (T.W. Ruefli).

<sup>1</sup> China Statistical Yearbook, 2007.

prices plus entrepreneurship. Freely set prices provide signals as well as incentives for resource allocations; while entrepreneurs may act in advance of known prices and make judgmental decisions on what to produce and how to produce it under uncertainty [1].

Entrepreneurs are price-takers as well as price-makers. In fact, in an uncertain world, as is always the case in a market economy, the most important decision is “discovering the relevant prices” [2]; that is, foreseeing the price and the products or services that customers are willing to pay for, as well as the costs of production. Profit-pursuit and survival pressure drive entrepreneurs to organize enterprises efficiently, and to innovate new products, new production technologies, new business models and new organizations. It is through entrepreneurial initiatives that an economy grows and thrives [3].

This definition provides guidance for understanding China’s transition from a planned to a market economy. The key to the success of Chinese economic reform has been liberalization of prices through a dual-track system, and the rise of entrepreneurs through the (1) development of non-state sectors, and (2) privatization of the state sector. Under the previous planning-only regime, prices were set by the government and played little role in developing new resources allocations. Both production and investment decisions were made by officials according to their “social goals,” rather than by entrepreneurs for purposes of profit. Since the beginning of the reform period, prices have been gradually freed and thus become major signals for redirecting allocations of resources. At the same time, entrepreneurs have gradually replaced bureaucrats in making economic decisions—although the government still holds considerable control rights, even today.

The importance of liberalizing prices is shown by history. Looking globally, we find that the *wealth gap* between countries is, in general, very different from the *resource gap*. In fact, many developed countries, using liberalized pricing systems, are relatively poor in their natural resources, while many under-developed countries are relatively resource rich.

“Entrepreneurial talents” are considered one of the most important factors of economic development.<sup>2</sup> There are two basic facts about the distribution of such talents. First, while entrepreneurs are a phenomenon of the market economy, entrepreneurial talents have always existed. However, in the long history prior to China’s industrial revolution, those talents were engaged mainly in military activities, political struggles, and government services, rather than in productive activities, as they are in Western countries today. Regarding the latter, marketing has, in particular, led to the efficient allocation of entrepreneurial talent [4].

Further, although everyone may have some degree of decision-making ability, only a relatively few can be said to be entrepreneurial. Entrepreneurial talents are thus considered a scarce resource in virtually any national society.

While endowments of these talents are important for economic development, even more important is their allocation across various uses, especially the efficient matching of entrepreneurial talents and production technologies [5]. As Bianchi [5] and Baumol [6] have argued, while the supply of entrepreneurial talent varies amongst societies, the productive contribution of a society’s entrepreneurial activities varies much more because of their participation in activities such as innovation, in contrast to selected unproductive (even destructive) activities.<sup>3</sup>

<sup>2</sup> By “entrepreneurial talent,” we refer to individuals in the population who have a relatively strong ability to foresee the future in an uncertain world, and innovate new products or services, and modes of production.

<sup>3</sup> A similar argument is also made by Murphy et al. [11].

Baumol’s proposition provides a powerful explanation for the astonishing economic growth of China in the past three decades [6]. Of the many resulting changes, perhaps the most important is *the movement of entrepreneurial talents from the government and agriculture, to the business and industrial sectors*. This change is unprecedented in 2000 years of Chinese history. Many more entrepreneurial individuals thus now create value rather than simply (re)distributing income and resources. Many suggest that this is the principal reason for the rapid growth of both wealth and income in the country.

Underlying the rise of entrepreneurship is a change in property rights, where we define such rights as an incentive and accountability system to link one’s action to his (or her) expectations of return [7]. When property rights are well defined and protected by law and social norms, everyone should, by definition, be fully accountable and responsible for his (or her) own behavior. When property rights are not well defined, both prices and incentives may become distorted, wherein entrepreneurs might be less than fully productive.<sup>4</sup>

Of course, in reality, property rights are generally vaguely defined. However, the nature and level of such vagueness varies from country to country, and from time to time. The distribution of property rights is less a dichotomy than a continuum between complete vagueness and complete clarity. Generally, the validity of price signals and incentives of entrepreneurs are positively correlated with the clarity of property rights, with the former converging as the latter rises. An economy can thus grow as long as the vagueness of its property rights is decreasing.

This point is crucial for understanding the growth of the Chinese economy in the past three decades. This success provides neither conflict with property rights theory (e.g. [2,8–10]) nor does it require support of free ownership theory. In China, property rights remain ill-defined and protected, while firm ownership is still vague compared to most developed economies. Nevertheless, China’s economic development is occurring, at least in part, because the country has been moving increasingly to a private property-based economy from a more position-based rights economy.

To be sure, property rights have become less vague and better protected in the past 30 years. The success of rural reform in the late 1970s and early 1980s, for example, has its source in the contracting-out of land properties to rural households. The resulting property rights are now much better defined under the new household-contract system than under the earlier collective commune system.

In urban settings, under the planned economy, almost all economic rights were position-based, and non-public businesses were considered illegal. During reform, however, the government has taken several steps to grant legal status to the private sector. Self-employed businesses were legalized in 1982. Privately owned enterprises eventually obtained legal status in 1988, but only after long debate. Protection of private property rights was explicitly written into the new Constitution in 2004. By end of the 1990s,

<sup>4</sup> In a market economy, the firm is one form of exchange (Coase [8]). When property rights can be freely exchanged, firms will emerge. Ownership of the firm is a contractual arrangement among different participants (Alchian and Demsetz [9]). While, theoretically, ownership of a firm may be equally shared by all participants, the contractual arrangement is typically asymmetric: Some become the owners (employers) with assignment of residual claim (profits and rents) and control rights, while others become employees by taking contractual income from an agreement to obey the authority of employers (within limits). This “profit system” can be understood as an accountability system (Zhang [12]). In most industries, and in most cases, such a system provides the best incentive for entrepreneurs to make efficient decisions.

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