

XU CHENGGANG

## CELEBRATION FOR JANOS KORNAI'S 90<sup>TH</sup> BIRTHDAY

*Xu Chenggang a Cheung Kong Graduate School of Business professzora. PhD fokozatát a Harvard Egyetemen Kornai János tanítványaként 1991-ben szerezte. Korábban a Hongkongi Egyetem professzora volt, emellett a London School of Economics-on tanított 1991-2009 között. Qian Yingyivel megosztva elsőként kapta meg egy kínai magánalapítvány, a Nemzeti Közgazdasági Alapítvány Kínai Közgazdasági Díját. Jelenleg is tagja a Ronald Coase Institute-nak, valamint társszerkesztője több nemzetközi és nemzeti folyóiratnak is.*

**Köz-Gazdaság:** Firstly, would you please tell us your personal contacts with him when you were his student at Harvard University.

**Xu Chenggang:** In 1985, Kornai gave his brand new course on Socialist System at Harvard University for the first time, and my contacts with him began from attending this class. This course was offered to PhD students in economics. But what made it completely different from all other elective courses for doctoral students was, dozens of students from different disciplines came to attend his class and the classroom was completely packed, while for other elective courses, it would be good enough if more than twenty students attended.

He soon chose me and Yingyi (my classmate and friend) to be his research assistants, because this course was actually part of his work concerning the socialist system. His course was also his book-writing process. As a research assistant I was responsible for filing documents for his works. We had frequent interaction since then.

When I worked as his research assistant, most of the earliest job was to collect data about China for his writings. On the one hand, as a teacher, he respected all the students; on the other hand, he was very critical of me and set strict standards for me. So, as the Chinese saying goes, he was like the amalgamation of ice and fire that was very kind to you for one moment, and would be very tough for the next moment.

At that time, I was a newcomer from abroad. Although I had worked in the Chinese Academy of Social Sciences before going abroad, after all, I had never had any idea of the strict standards of the international academic circle, nor did I really understand the corresponding requirements. When working as his research assistant, we had to put the data listed in corresponding forms according to his request. Rather than just a kind of forms, the tabulation of the data sheets was actually a very important part of the research work. Rather than a simple task of listing numbers on the sheet, it required you to think about the content contained by these figures, and then accordingly produce the appropriate forms. As a novice of being his research assistant, I was naive enough to just put the numbers together in a stereotyped way. Then I was severely criticized by Kornai. He said, what was the significance by putting these data together? Actually, this lesson was very important for my later academic development. Kornai was concerned with

all the details. So as his student, one would feel that he was too harsh. But on the other hand, if you can understand the implications behind such kind of strict requirements, you can actually benefit from it for the entire life.

The appointment of Qian Yingyi and me, two Chinese students, to be his research assistants contained a unique love for both of us totally different from that towards other students. In addition to the personal reasons, there was also his concern for China. So, when studying in this university, we were regularly invited to his home, especially holidays or important occasions. With his wife cooking in the kitchen, we chatted about all kinds of available information. We can recognize that his course was totally different from all the other courses in Harvard University, because all the content of other courses were the things that we knew nothing about. But on this course, even if he did not point out where these detailed stories happened we can figure out that these stories told by Kornai happened in China. We, his students, may also be special for him. He may also find that we had different reactions towards his lecture from students of other countries, and naturally, our teacher-student interaction had become increasingly frequent.

The most critical moment enhancing our teacher-student relationship was the occurrence of Tiananmen Event happened in the spring of 1989 when students in Beijing marched in front of Tiananmen Square for demonstrations, and occupied there for a hunger strike. We, from Harvard University, made efforts to support the Beijing students. With Gorbachev's visit to China, the world's attention was focused on Beijing due to the media exposure, with Tiananmen Square being the highlight of the world. Later Government in Beijing implemented the martial law, leaving the situation of Tiananmen Square at daggers drawn and the conflict on the verge of breaking out. Kornai said the situation in the period from the day of the proclamation of martial law to the June 4 reminded him of the situation in Hungary of 1956.

In fact, such feeling had been discussed in our daily chat. He remembered that when the Hungarian Incident broke out in 1956, the tanks of Soviet Red Army were directly driven into the territory of Hungary, leaving Hungary in a miserable condition. However, we retorted that the situation in China was different from that in Hungary. Our confidence came from the fact that the miserable conditions caused by Soviet Red Army consisting of Soviets, rather than Hungarians, but the PLA (people's liberation army) would not harm their compatriots. He denied the existence of such kinds of difference. This chat was occurred a long time before 1989.

While in 1989, the Tiananmen Event really brought Kornai back to Hungarian Incident in 1956. Even though he worried a lot about the Chinese students and the future of China, he could do nothing every day but watch the live broadcast of various television stations from Tiananmen Square all the time, just as what we can do. During that period, as far as I knew, he was the only professor who was concerned with China as our Chinese. Other professors were also concerned about this, but they would not show as much empathy as we did. During that time in 1989, only Kornai invited us more than once to his home to discuss the related issues.

These were not much related to the research work. From the perspective of the research work, Kornai was the major supervisor during my writing of the doctoral dissertation. During this process, he always emphasized that any work should be closely tied to phenomenon and systems under observation. He was harshly critical of the

opinion held by mainstream traditional ways in economics originated from identifying or building a personal utility function, which was directly related to his famous work -- *Anti-Equilibrium*. We were enjoined to think about the starting point of research when performing researches.

During the process of preparing the doctoral dissertation, the most important guidance from him was not be limited by the narrow economic objects and methodology, namely, in addition to the pure economic phenomenon, I should connect the phenomenon with the real world where politics and the economy shall be interwoven with each other, which was also the requirements for himself.

When learning from Kornai, I carried out wide discussion with him on the progressive reform, cautiously-advancing reform and the issue of economic reform followed by political reform. His attitude towards these issues was of sharp criticism in which, the most critical one was that being progressive may not always be available in all reforms in the world. For example, the transformation from the single-party system to the multi-party system was a sudden change from 1 to 2, instead of being progressive. We carried out a lot of discussion on these issues, including but not limited to academic ones.

For example, according to Kornai's opinion, Boris Yeltsin's election to the presidency of Russian Federation prior to Soviet Union's collapse was a sudden change. In 1989, my father Xu Liangying initiated an open letter calling for political democratization, signed by 42 famous scientists and writers, including Wang Ganchang. It was the first time that so many top intellectuals in China declared publicly for political reform since reform and opening up. When talking about this event which made a great international impact at the time, Kornai remarked that Chinese reformers were brave and hardworking, even though they were only on the way of issuing an open letter. In fact, real political reform shall be able to trigger the multi-party competition, rather than one-party rule.

**Köz-Gazdaság:** You just mentioned that the relationship between you and Kornai has been lasting for many years. From the perspective of academy, he taught you how to start academic study, identify basic standards, handle the academic career, establish the academic methodology, develop a good discussion on academic issues and connect social issues with your academic topics, and all these played a special role in basic enlightenment. From the personal development point of view, he was a special supervisor to you, so actually such kind of relationship shall be a sense of spiritual and psychological dependence when encountered with the conflicts in different value systems between China and America after first arriving in the western world?

**Xu Chenggang:** Yeah, it was very lucky for me to have Professor Kornai to be my supervisor. Such opportunity was very rare, and Professor Kornai really means a lot to me. In addition to the help in pure academy, he helped me form an important basic understanding, which sometimes beyond the expression of language and words. There is resonance between the socialist system he talked about and the phenomenon in China, and such resonance and understanding came from our special background. It was a God-given luck, apart from similar systems we had experienced, what's more

important, Kornai was the internationally-accepted best expert in researching socialist system and the one who had the best understanding about socialist system in the world. My obsession with socialist system can be traced back to the Cultural Revolution in 1966. After admitted by Harvard University, I was not sure if I could find a suitable supervisor sharing the same interest in the topics that I wanted to dig into. However, I could not believe that I was so lucky to learn from the best supervisor in the world, who has the most profound understanding of the socialist system. It's the God's will.

**Köz-Gazdaság: This communication between thoughts is actually helpful to your study, too.**

**Xu Chenggang:** Yes, the profound help he gave me has been lasting from that moment until today. Let me explain with one specific example; take the essay I published on JEL in 2011 as an example. On the international conference of the 20<sup>th</sup> anniversary of tearing down Berlin Wall held in Helsinki, Finland, 2009, I presented my ideas from this essay, and on my walk with Kornai to a nearby island around Helsinki, we discussed while walking for about 1 hour. On one hand, he appraised my analysis of Chinese system. On the other hand, he put forward the criticism on my essay. He thought that I paid excessive attention to the economy and economic development; while for China, the more important and urgent problem was the danger caused by its political system and its influence on the future, of which I were well aware, but I just failed to deliver such danger and adverse influence to readers who may have no idea of this information. According to his suggestions, any honest scholar shall present readers with something beyond their knowledge but within the scholar's scope. In this hour of talk, he also pointed out many specific details which were far beyond the range of an essay, which still imposed influence on the basic aspects of my research work today.

**Köz-Gazdaság: Let's continue what we discussed just now. There is a basic feature in Kornai's research, which is that he deems the relationship between society and economy as a whole, and believes that this relationship shall be well studied in a scientific way. This research method seems to become more and more popular in recent decades. In your opinion, if there is a way to review social and economic problems in future, which topics and subjects are the most important in your idea?**

**Xu Chenggang:** Indeed, in the recent two decades, the study on new political economics, new institutional economics has developed rapidly, which also has caused earth-shaking changes, namely, expanding economics from the pure economy realm defined narrowly in the past through the narrow research way to new political economics and new institutional economics. The driving factor behind this earth-shaking change owes much to the breakdown of Soviet Union and Eastern Europe Bloc and the subsequent large-scale transition. Kornai has been recognized as the world leading scholar with respect to the research of breakdown and transition of Soviet Union and Eastern Europe Bloc.

All transitional countries were encountered with very basic difficulties, which can also be deemed as the great challenges of economics. In the early stage of transition, we can see that except a few countries like China, many transiting economies fall into economic recession. However, on the other hand, they also achieved a significant progress by establishing the democratic political system. Later their economy recovered bit by bit from all aspects. But after financial crisis, many transitional countries have changed from the democratic political system to political authoritarianism. This is a challenge not only to their society, but also to the academic circle, since there is severe lack of basic research on this problem from the perspective of academy.

Among the scholars of new political economics, new institutional economics nowadays, there aren't sufficient scholars concerning about these significant problems. In addition to the Soviet Union and Eastern Europe Bloc, China is an exception of transiting economy. Although in the transition process of China, just from the perspective of economic development, it seemed that China was under stable development in a relatively fast speed. However, there were basic obstacles in the political and overall system. There was no corresponding political reform matching with the economic reform, which formed obstacles to its economic reform and further development. Especially in recent years, the reversal appeared. In general direction, the reversal of China is similar with transitional countries in Soviet Union and Eastern Europe Bloc. However, the reversal of transitional countries from Soviet Union and Eastern Europe Bloc is from democratic system to authoritarianism, while China is changing from authoritarianism to totalitarianism. What impact will these phenomena have on Chinese economic reform? What impact on Chinese society? As for all kinds of these problems, there are few academic studies focusing on these significant problems. Therefore, this is a great challenge in academic circle, requiring young scholars to pay more attention to and put efforts into it.

**Köz-Gazdaság: The widely recognized two contributions made by Kornai in the economics field are: one is *Anti-Equilibrium* published in 1971, and the other is the soft-budget constraint theory (SBC) put forward in *Economics of Shortage* in 1980. Do you agree that these are the two greatest contributions made by Kornai? If they are, which one do you think is more important to our current economics study?**

**Xu Chenggang:** Judging from his completed works, these two works should be of the greatest impact, but actually there is another work with tremendous impact, *Socialist System*. Therefore, it should be these three works with the greatest influence.

The early work-- *Anti-Equilibrium* put forward fundamental challenge to neoclassical economics from the methodology and research objects. *Anti-Equilibrium* challenged fundamentally to mainstream economics; therefore it is hardly accepted in the mainstream economics circle. However, I believe that the basic ideas contained will enlighten future study significantly.

Let's make an analogy. This is like that after putting forward general relativity, the whole life of Einstein since then was devoted to unified field theory, even though Einstein failed to complete it. Afterwards, numerous physicists follow by this theory and are

enlightened by it. Although studies on unified field theory in today's physical field don't comply with Einstein's unified field theory in all specific contents, the idea of the unified field theory is the source of enlightenment of the researchers in the following years. I would like to say that Kornai's anti-equilibrium theory has inspired and will inspire young scholars from generation to generation. Although it may not be acceptable to all, people that can be inspired shall be scholars with a critical spirit.

As to soft-budget constraint theory, it's an important theory without any controversy in academic circle, which is a great breakthrough. It's not only the most influential work of Kornai, but also the greatest one made by social scientists in the background of Soviet Union and Eastern Europe Bloc. No matter in East-European countries, or in Russia, other member countries of former Soviet Union joining in the republican system, or even in China, this theory has been fully verified, and gained the complete understanding of scholars and policymakers in all these countries. The impact of soft-budget constraint theory goes far beyond the central planned economy before the reform, which even fundamentally rectifies our understanding of the market economy.

The so-called soft-budget constraint phenomena can be wisely observed in the market economy (e.g. in the United States, Japan and South Korea). On the other hand, through the analysis and discussions of the phenomenon of soft-budget constraint, it, in turn, will help us understand the capitalist system and the market economy. In the market policy based on the private ownership, why the subject we can see is hard-budget constraint? But why, once the government is deeply engaged, even if in the market economy of private ownership, there will be the soft-budget constraint? While in the state-owned market economy, the so-called market socialism soft-budget constraint is the basic law. How to understand these phenomena? The depth and breadth of the problem overwhelmingly exceeds the simple socialist economy, the planned economy, the economy in reform and the economy in transition. The problem is one of the most basic parts of the entire economics. Without the knowledge of this problem, we have no detailed ideas of capitalism. Therefore, from this perspective, the soft-budget constraint theory is one of the proven and most influential theories.

In addition, the companion work of Kornai's work on the socialist system is one masterpiece on the capitalist system. Due to the poor health of Kornai, this book was not completed. But recently, a brief version was published. When discussing his contribution to the study of the socialist system, we should put those works together. The reason is that the academic significance of the discussion of the socialist system has never been limited to the socialist system itself. There is a misunderstanding that there is no more any socialist system based on the public ownership system. Thus any academic works on the discussion of the system demised are equivalent to discuss dinosaurs in biology, which is only confined to a small group of people, unworthy of universal concern. In fact, socialism mirrors capitalism. In theory, a study starting from the extreme phenomenon can help simplify the analysis and understand the system playing the most basic role. In reality, one end of the extreme phenomenon is socialism with full state ownership, and the other end is the purely private market economy with the smallest government, covering all kinds of real economy forms. Without knowledge of these two extremes, we cannot have complete understanding of capitalism. While discussing the extreme of socialism, the most important contribution is from Kornai's

works. For example, with regard to the most popular work-- *Capital in the Twenty-First Century*, which is very popular in the public, its tremendous influence is partly because that people are extremely ignorant of socialism. In case that only one extreme of capitalism is observed, people will mistakenly believe that the problem seen is caused by the evil system of capitalism when encountered with the problems of capitalism.

**Köz-Gazdaság:** To sum up, you think that Kornai's contribution to economics has three parts of the work which are particularly important: one is anti-equilibrium theory, one is soft constraint theory, and another one is the theory on socialist system and capitalist system. These works provide questions and challenges for the foundation of economics, and also provide inspiration for the young scholars who will follow up to continue their economics research.

**Xu Chenggang:** To a considerable extent, it can be considered that the theory of socialist system and capitalist system derived from Kornai's soft-budget constraint theory is the result of his application of anti-equilibrium theory. Anti-equilibrium theory is an abstract discussion. When this theory not only challenges the mainstream economics from the foundation but also is highly abstract, few people can really grasp the whole idea of it. In contrast, the reason for that the soft-budget constraint theory and his theory of socialist system are more widely accepted is that they are more specific and have been validated. After understanding his findings, the best scholars will be inspired to rethink those ideas of the anti-equilibrium theory.

**Köz-Gazdaság:** As you just said, if we view the socialist system and the capitalist system as two extreme phenomena being mirror images of each other, can the soft-budget constraint be used to make new interpretations of many social phenomena, such as financial crises?

**Xu Chenggang:** My view is, with regard to the global financial crisis in 2008, the very important underlying mechanism is the soft-budget constraint, while this point is not proposed in all kinds of modern literatures I know of. Why the main mechanism behind is the soft-budget constraint? We know that the mechanism which directly triggers the 2008 financial crisis is the subprime mortgage crisis. What is subprime mortgage? Subprime mortgage is a mortgage loan provided by the financial institution with an extremely high leverage. When performing the mortgage, it can be known that if house prices fall, many individuals who accept such loans are unable to repay them. Thus, it is called as subprime mortgage. When the highly leveraged subprime mortgage becomes a universal social phenomenon, the economy cannot be sustained. A major financial crisis erupted as a result. The question is why the subprime mortgage is generated? Why there is no subprime mortgage in the past? Why is it happening now? These are important issues which need to be understood. The reason I call it soft-budget constraint is just like this. In the traditional capitalist system, the institutions that issue housing loans are banks. Banks issue mortgage loans, and the mortgaged real

estate will be recorded in their own balance sheet. Related to the bank's own security, facing the threat of bankruptcy of its own, the bank will be concerned about the nature of mortgage assets, the borrower's repayment ability and credit, etc. This is the result brought about due to the hard-budget constraint in the traditional capitalist economy. However, since the 1990's, the so-called financial innovation has been introduced, whose core content is that the lender can put his mortgage assets packaged for sale as a financial product. At the same time, those who purchase the financial product can repackage it for sale once more. After several times of such transactions, the relationship between the borrower and the ultimate investor would be very estranged, as a result, there seems to be no relation between the lender's bankruptcy and the bankruptcy of the investor. Thus it shakes the foundation of capitalism- hard-budget constraint. The hard-budget constraint confronting everyone in the capitalist economy has changed into the soft-budget constraint, which is the root causing the crisis. To sum up, Kornai pointed out that the nature of capitalism was hard-budget constraint. From this mechanism, if the hard-budget constraint is damaged, whether the soft-budget constraint comes from the government or other sources, as long as it is a soft-budget constraint, capitalism cannot run stably. The financial crisis is one of the manifestations. The discussions of the 2008 financial crisis, from psychological factors (such as greed, etc.) or simple financial regulation and monetary policy, have not seized the key for the issue.

**Köz-Gazdaság: Kornai's new book published in 2013 challenged the mainstream economics once more. He described that the supply always exceeded the demand in the capitalist system, which caused much waste, but such also constituted a basic driving force for social progress. What's your viewpoint?**

**Xu Chenggang:** This work is the abridged edition of his masterpiece about the capitalist system. Together with his *Socialist System*, this work makes overall contributions to the basic systems of the whole world. From another perspective, we have mentioned that the anti-equilibrium theory is expressed very abstractly, and both masterpieces - *Socialist System* and *Capitalist System*-- reflect the specific results of the anti-equilibrium theory. According to his description, the basic characteristic of the capitalist system is surplus and, in contrast, the basic characteristic of the socialist system is shortage. Both surplus and shortage conflict with equilibrium. This is a specific expression of anti-equilibrium theory provided by him.

Based on this, what is the motive force of development for classic socialist system and typical capitalist system? In classic socialist society, the motive force of development is the shortage. The central plan focuses on shortage every day and tries to make it up. However, the development of capitalism is dynamic. It is a mechanism proposed by Schumpeter and featured by creative destruction and the basic motive force behind the mechanism is surplus. Schumpeter failed to recognize the mechanism clearly, but Kornai makes it. When enterprises are encountered with the massive surplus in the market, how to survive? On one side, they are encountered with the hard-budget constraint, which means over surplus will cause losses and bankruptcy; for survival, they have to reform, innovate and break through the original equilibrium. They can



only obtain great profits with the monopoly right from the creation of new products. Nevertheless, once the new products emerge, the large amount of old ones will become surplus. Therefore, surplus is the motive force of innovation on one hand; on the other hand, it is also the product of innovation. The analysis of Kornai is very incisive. The discussion about concept creates an important enlightenment for the new generation of economists. The masterpiece, published by Oxford Press in 2013, failed to attract sufficient attention of young economists. If young economists, under the enlightenment of Kornai's theories, composed them into theoretical models, and then conducted empirical tests, they would likely to achieve a further breakthrough in economics.

**Köz-Gazdaság: In your opinion, what is the direct academic impact of Kornai on you? What direct enlightenment did you get from the methodology to specific problems in handling with economic problems?**

**Xu Chenggang:** It is mainly reflected in two aspects, namely from the universal perspective and from the specific perspective. From the universal perspective, it breaks the narrow boundaries for discipline division. Among the most excellent scholars, Kornai makes the greatest effort to break the artificially delimited boundaries. He always emphasizes that most so-called pure economic phenomena are not merely pure economic phenomena.

His soft-budget constraint theory has the most prominent impact on my research direction. This theory is actually a universal basic phenomenon sourced from the basic social system with universal consequences. When exploring more deeply and carefully, you will find that it has very profound and wide influence and our recognition of the theory is far from enough.

Apart from the published works, I have prepared some other unpublished works which were considered important under Kornai's influence. I researched the impact of soft-budget constraint on economic growth, and found that the soft-budget constraint influenced the research and development, innovation and even the long-term economic growth. I have accumulated some works, but it is far from the expected targets, so more researches should be further carried out. In addition, I have done some research on the relationship between soft-budget constraint and financial crisis. I have mentioned the explanation about the financial crisis in 2008, but the idea has not been transformed into a formal theoretical model and no systematic empirical test has been made. However, I believe the intuition from large quantities of observations is correct and reliable.

**Köz-Gazdaság: Kornai devoted his lifetime to researching on socialist system. Currently, China is the largest socialist country and meeting a series of problems concerning economic development in strategy. In your opinion, how can we apply the academic achievements of Kornai to explain the Chinese phenomenon and what important enlightenment will they bring to the next step of China's development? In particular, China is carrying out several important national strategies, including „Belt and Road Initiative”, innovation, and reform of state-owned enterprises.**

**Xu Chenggang:** As regards its application in China, the theories of Kornai have significantly influenced China's economic reform and strategic design as early as 1980s. In the 1980s and 1990s, the top leaders knew the basic concepts and points of Kornai. According to which, China has made great achievements in governance of soft-budget, which have laid the foundation for its fast economic growth. Unfortunately, the active scholars and policy-makers in China diverted their attention from soft-budget constraint from the beginning of the 21<sup>st</sup> century. One of the consequences is resulting in the reversal development of China after obtaining a series of achievements in the past reform. The problems concerning soft-budget constraint previously under control have rapidly emerged in new forms in the recent decades. The core problem of state-owned enterprise reform is to solve the problem concerning soft-budget constraint. From the perspectives of theories and policies, all early achievements were obtained along this direction. The problem of state-owned enterprises goes worse to the extreme, which arises from the resurgence of soft-budget constraint problems. The root cause of formation of today's so-called zombie enterprises is that the insolvent state-owned enterprises fail to go bankrupt due to the soft-budget constraint problems. The phrase „zombie enterprises” shows the serious consequences caused by the soft-budget constraint. The second consequence is huge excessive capacity and the third one is high debt and fast deterioration.

China's financial risk problem, a concern receiving the national attention, is actually a soft-budget constraint problem presented in various forms as a result of high debt and emergence of zombie enterprises. All kinds of debts may continually develop to a very dangerous level. The underlying cause of all these conditions lies in long-term neglect of the soft-budget constraint and its background system. Under this system, new forms of soft-budget constraint constantly emerge. The soft-budget constraint is ubiquitous even in most listed companies in Chinese financial market. The base of financial market is hard-budget constraint, in other words, when an enterprise has poor corporate performance, shareholders will undersell its stocks in the financial market. The enterprises whose stocks are undersold will go bankrupt or be merged or acquired, which presents the hard-budget constraint. However, the situation is different in Chinese financial market. Many state-owned listed enterprises are poor in performance and even insolvent, but they can get various capitals in the form of soft-budget constraint. Therefore, it distorts not only the incentive mechanism of enterprises, but also basic information and incentive mechanism of the market. Stock investors will reckon the response of the government and even calculate the moment when an important insolvent enterprise reaches the worst point, namely the turning point. They will try their luck. This explains why there is no clear relationship between Chinese financial market and the fundamentals. Soft-budget constraint theory is the basis for explaining why the Chinese financial market cannot operate effectively.

The abnormal Chinese financial market is generated under two institutional backgrounds, namely lack of laws and regulations and soft-budget constraint. A financial market full of soft-budget constraints is not the market generally discussed in economics and finance. Unfortunately, the number of scholars in the current Chinese economic circle who focuses on the theory of Kornai is much less than before,

particularly young scholars returning after overseas study. Without the guidance of the theory of Kornai, applying the theory of developed countries mechanically, copying two popular tools from literature and putting them in China's actual conditions blindly will result in misunderstanding or being useless. This kind of research is usually misled from the start point, so the works based on these researches will mislead other people and policies when applied in the policy making.

A muddled concept is that the soft-budget constraint theory was proposed in the past against the planned economy under reform, which is out of date now. In fact, when tracing back to the original concepts of most of today's economic theories, we find that most concepts are proposed earlier than soft-budget constraint. However, the concept of soft-budget constraint can correctly grasp large quantities of basic problems existing in China.

**Köz-Gazdaság: In recent years, we saw a serious surplus in Chinese commodity market and many soft-budget constraint problems in the financial market, but how should we research and explain the coexistence of the two situations?**

**Xu Chenggang:** This is a challenge to the economics, which also required innovation in the economics. The theory proposed by Kornai discusses the state-owned socialist economy or reformed socialist economy. In such socialist system, the soft-budget constraint will generate the shortage. The Chinese economic subject is major featured with private economy, but state-owned enterprises take advantage of their soft-budget constraint as well as monopoly position and scale expansion to squeeze the profits produced by private enterprises. Their soft-budget constraints cause a huge surplus in economics.

This is my superficial explanation of the observed phenomena. It is unprecedented challenging to transform the observation into a strict theory and constructing theoretical and empirical test models. Nevertheless, any theory and validation constructed towards this direction may promote the rapid development of economics because it is not only brand-new in economics, but also a guidance of Chinese economic reform in policy. Finally, I'd like to give a brief summary. Kornai made very important contributions to both basic economic research and practical application in explaining many major problems about socialist system and capitalist system and policy-making. Similar to Schumpeter, Lange and Hayek, his works will also have a long-standing impact on the academic world.