

China's Capitalism

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Abstract

The paper combines a broad theoretical framework of comparable capitalism with the insights from new economic sociology and new institutional economics to understand and assess mechanisms of China's evolution. During the last three decades China's economic system has undergone a great transformation from communism to some form of state-led capitalism. The evolutionary approach that balanced the interests of economic and political actors led to the gradual introduction of a capitalist institutional framework, but also preserved the immense role of the Communist Party. In the course of the reforms, former direct control over the economy has been replaced by more discretionary measures like corporate governance (which conserved the extensive patronage system), and Party affiliation (which allowed for political penetration of the private sector). Supplying examples of mounting economic waste, I argue that China's present variety of capitalism is hardly an optimal solution, and the further development will strictly depend on state and Party withdrawal from economic control.

Introduction

At the close of Cultural Revolution period, Chinese economy faced giant inefficiencies that hampered living standards and growth of production. The legacy of institutional deterioration resulted in China's underperformance not only against

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market economies, but also in the specific context of command economy. In 1978, the Communist Party launched set of basic reforms that were supposed to improve the operation of existing planned system. These small adjustments unleashed forces that brought unprecedented economic growth and led to emergence of 'socialism with Chinese characteristics' (*zhongguo tese shehui zhuyi*). But the term coined by the father of the reforms – Deng Xiaoping ('Build socialism with Chinese characteristics') – and repeated ever since in official party documents has disguised the true nature of the transition. First, the forces responsible for dragging over half a billion people from poverty followed ideas put by Sombart (2001: 6) to describe the spirit of capitalism: acquisition, competition and rationality rather than ideas of any specific version of socialism. Second, China's institutional framework and socio-economic relations – the fundamental cause of development (Rodrik, Subramanian, Trebbi 2004; Acemoglu, Johnson, Robinson 2005) – confirm their capitalistic character, i.e. ability to sustain accumulation and reproduction of capital. In the pre-reform period China's private sector was officially non-existing. At the end of 2010, according to World Bank (2012: 110) estimates, non-state sector provided about 70% of country's industrial output and 80% of the total employment. Privatisation of Chinese economy was accompanied by formation of middle class and bourgeoisie that, according to some estimates, amounted to 100 million households at the end of 2010 (Li 2010: 10). Nevertheless, scholars point out the core feature of the China's system that clearly weakens the capitalistic notion. The Communist Party's general approach to economic policy has been gradually shifting toward the market, but more than thirty years on it still retains monopolistic political power and partial control over production and allocation of resources.

A system that combines some organizational forms of pre-existing socialist redistributive economy with emerging market institutions has been labelled by Nee (1992) as hybrid capitalism. This definition is a good starting point for a discussion over the nature of Chinese economy. As King and Szelenyi (2005: 207) argue, transition from the communist system is very different from previous classical roads to capitalism. In case of all post-communist countries market economy evolved from a system that had eradicated an institution of private ownership and the class of private proprietors. According to the concept of path dependence, this initial organisational framework would dictate strong persistence of the state (or former political actors) in a new institutional order. Indeed, empirical evidence confirms the replication of some pre-existing arrangements in China's, as well as in East European versions of capitalism (Fligstein 1996). As Stark (1996: 995) insightfully noted, even

the boldest economic reforms entailed the capitalism to be rebuild 'not on the ruins but with the ruins of communism'.

In the early stage of Chinese reforms, institutional innovations, i.e. changes implemented to the formal and informal 'rules of the game', originated not on the government level, but rather on micro level. New economic actors and market-guided practices had emerged without formal legislation and, if happened to be effective, *ex post* accepted by some formal rules (Nee 2005: 61). This approach reminds of a more general pattern described by Granovetter and Swedberg (1992: 17), in which institutions are 'the result of a slow, social creation' that after adjusting to multiple interest finally become 'the way things are done'. In the course of the reforms, the more spontaneous, decentralized version of capitalism has been replaced by state-led economic strategy, in which the role of politics paradoxically increased rather than declined. Such institutional order, where state actors set the regulations and remain directly involved in guiding transactions at the micro level was called by Nee and Opper (2007) politicized capitalism and described as a transitory state. Nevertheless, it is far from certain that the ultimate goal of the Chinese hybrid capitalism is, as they expect, full market economy.

The discussion over the nature of Chinese capitalism with its strong and leading state has several far reaching consequences. Global financial crisis undermined the credibility of dominating liberal capitalism paradigm with its limited government, minimal financial regulation and free-market allocation of credit. Very different institutional arrangement was part of China's model. Tight management of the exchange rate, control of capital flows and expansionary investment policy protected Chinese economy from heavy shock in the late 2000s and during the Asian Crisis in the late 1990s. In his press commentary, in the aftermath of the Lehman Brother's collapse, Fukuyama ('The End of America, Inc.') admitted that China's state-guided model 'is looking more and more attractive'. The confirmation of its growing appeal came in 2012, when *The Economist* ('State capitalism', Special Report) announced the rise of new form of state capitalism in emerging markets, with China as the biggest and most successful economy in the camp.

As Krug and Hendrischke (2008) noticed from their institutional perspective, heterogeneity of business environments across China provides empirical evidences satisfying many alternative views on the nature of its capitalism. Thus, in order to provide more general picture of China's system, the analysis will have to combine

1 As drawn from North's (1990: 4) definition of institutions.

broad theoretical framework of comparable capitalism with the insights from new economic sociology and new institutional economics.

According to the first conceptual scheme, most of national capitalism systems are uniquely organised. Economic and social differences at the beginning of transition to capitalism are followed by different choices made in organisation of relations between system's main players: government, firms and workers. As a result, every transition produces a new variety of capitalism. However, looking closer at the countries' institutional arrangements, one can distinguish clusters with different internal logic. Taking the firm-center approach Hall and Soskice (2001) present two ideal-types of capitalism: Liberal Market Economy (LME) and Coordinated Market Economy (CME). The former refers to the system in which company's behaviour is first and foremost dictated by market's demand and supply. The key feature of the latter is strategic interaction between the firm and the workers that results in coordinated outcomes. However, as Amable (2003) noticed, this binary classification does not grasp all of dimensions along which economies are differentiated. Hall and Soskice's division might be especially misleading in the case of China's institutional arrangement, which incorporates many LME's features on the firm-level, while staying thoroughly under the formal and informal influence of political actors. The more state-center approach, like the one introduced by Schmidt (2002) or Amable (2003), surely gives more insights into China's variety of capitalism, but still does not provide information about the system's dynamics. These will be drawn from other socio-economical frameworks that focus on social relations in which the economy is embedded (new economic sociology) and the evolution of specific markets and institutions (new institutional economics). The biggest advantage of comparative capitalism is that it introduces competition between different systems bringing forward a strong argument against the neoclassical mainstream and its focus on a market-driven 'one best way'. As can be explicitly drawn from works of *régulation school*, there is a 'good' form of regulation that secures stable growth accompanied by high welfare, and a 'bad' one that in the long-term guarantees neither. At the same time, other frameworks allow to place China's evolving organisational scheme in the context of social and institutional sustainability, bringing closer to the answer on whether China's state capitalism is Nash-like equilibrium.

The paper is divided into five sections. The next paragraph presents briefly the sequence of reforms with a special focus on the roots of institutional innovations. Section 3 describes the difference between China's successful gradual transformation and the collapse of partial reforms in other communist countries. Section 4 analyses China's variety of capitalism from the state-centred perspective and describes the

evolution of interests of political actors. A final section discusses the long-term implications of the state's persistence in the economy.

1. Capitalism from Below Turning Into Top-down Capitalism

As Naughton (1995: 7) pointed out, it is impossible that China's leaders had the blueprint of the transformation prepared when they started the reforms. Despite the lack of detailed strategy, the whole process followed a consistent and self-enforcing path that led to gradual implementation of market economy and stable economic growth. The beginning of reforms has been marked by small adjustments in the long suppressed rural sector. In order to improve agricultural production, the Communist Party decided in 1978 to raise state procurement prices for major crops, increase expenditure on rural investment and reshape management methods under the collective system (Lin 1992: 36). It is clear that these changes were designed to decrease effective tax rate without relaxing state monopoly on agricultural production. Instead, they initiated a complex series of interactions between peasants and country leaders that resulted in creation of family farming under so called Household Responsibility System². The secret pact of eighteen households in Xiaogang village, Anhui province signed in late 1978 is widely recognized as the first organised movement against collective farming. But as Zhou (1996) shows, at that time some individual experimentation of bribing cadres in order to get permit for sideline production was already in place. The spontaneous movement toward private farming was fast and widespread. By the time the Household Responsibility System was officially recognized (in late 1981), about 45% of collectives had already been decentralised (Lin, Cai, Li 1994: 21). This presumption of permissiveness in the countryside boosted agricultural production³ and encouraged further experimentation.

² Household Responsibility System established the contracting of collective farmlands to individual households initially for a 5-year lease period, later extended to 15 years (in 1984) and 30 years (in 1993).

³ According to official statistics cited by Lin (1992: 35), during the 1979–1984 period average annual growth of agricultural production was almost three times higher than in pre-reform communist period (1952–1978).

The next unanticipated institutional change was a rapid development of non-state sector in the form of Township and Village Enterprises (TVE). Rural industry owned and operated by local governments had existed in China since early 1970s, but was significantly constrained by limited access to resources and credit. At the outset of reforms TVEs produced no more than 9% of total industrial output (Naughton 1995: 144). Once central government relaxed the state monopoly on purchase of agricultural materials and encouraged urban firms to subcontract part of the work to rural enterprises, number of TVEs, their employment and total output started to grow rapidly⁴. Without formal national legislation the old centralised commune structure began to come apart and the responsibility for governmental operations and economic management were overtaken by townships and local economic committees respectively. The rise of TVEs has profoundly changed the whole economic system. Because TVEs existed outside the controlled system of production, they had to acquire the materials from the market and could sell the products on the market. That not only introduced more price signals to the economy, but also reduced the share of resources that were misallocated.

Liberalisation of micro-management and resource allocation was also following in the state-owned urban economy. In 1978 the government introduced some widely agreed (among Party members) initiatives aimed at expansion of enterprises' autonomy. At the same time it set off some more controversial measures that ended in a combination of plan and market. The state owned enterprises (SOEs) were allowed to retain their profit and produce outside the mandatory quotas. After the informal barter transactions were established between the companies, in 1983 government extended this quasi-market by letting SOEs to sell their excessive (that is outside the plan) output at negotiated prices. Thus, the Communist Party began the dual-track price system which allowed participating economic agents to be better off, while maintaining the flow of pre-reform transfers. Put it differently, out-of-the plan production added to the existing stock new stream of resources. Because mandatory quotas were fixed, the dual-track approach led to gradual marginalisation of central planning. By 1988 state enterprises got 60 percent of their inputs and sold 60 percent of their production at market prices (Lin, Cai, Li 1994: 16). Liberalisation of prices at margin was accompanied by managerial reforms that removed formally the Party secretary from his position of authority and put the responsibility for enterprise in the hands of contracted directors.

⁴ During the period 1981–1991 by 26,6%, 11,2% and 29,6% per annum respectively (Lin, Cai, Li 1994: 22–23)

Co-existence of clear market incentives in production and the rigidity of labour market became self-contradictory. The plan-track has been completely dissolved by 1993, but most of the SOEs still provided lifetime employment, housing, health care and pensions to a majority of their workers. By mid-1990s the amount of SOE's losses had begun to spin out of control (Lardy 1998: 34–35). The government undertook some top-down measures to promote efficiency. First, it set off a policy of privatizing small and medium SOEs while leaving the bigger enterprises that operated in critical sectors under state protection. The long-delayed privatisation took the form of managerial or employee buyouts, but also auctions in which many home-grown capitalists were participating. Second, by the late 1997 it pursued very aggressive restructuring of remaining SOEs that resulted in some companies' closures and massive layoffs. According to Giles, Park and Zhang (2005: 150) more than 45 million urban workers has been dismissed from 1995 to 2002, including 36 million from the state sector. In order to cushion the shock to laid-off (*xiagang*) workers, the government established re-employment centres and commanded work units to provide former employees with some basic allowances (Shi, Sato 2006: 2). However, thanks to increasing demand for labor stemmed from Foreign Direct Investment and already significant market-integrated private sector, the severity of adjustments was not as big as in Eastern Europe. Notwithstanding restrictions concerning rural-urban migrants, reforms created genuine labor market by allowing companies to make labor demand decisions and by freeing employees to choose their workplace (Chi, Freeman, Li 2012).

The dismantling of overemployment and social services provided by the companies were final measures to transform once loss-making SOEs into profit-maximizing firms. Although effects of these reforms were not as stunning as the rise of TVEs, studies conducted during that period have proved significant market integration and an increase in productivity of remaining SOEs (Groves, Hong, McMillan, Naughton 1994). As Chan and Unger (2009) show, many enterprises (including those in private hands) continued to look after the interests of their workforce and retirees in a former paternalistic fashion, but were not constrained by bureaucratic decisions anymore. The Communist Party has lost much of its ideological commitment to state-owned firms and, having taken more pragmatic approach, let them act like capitalists themselves. In order to bring more rationalisation to the firm-level, it also introduced in 1994 the Company Law. The legislation borrowed heavily from the legal framework of Western-style corporate governance and shareholders rights to provide the rules of a modern enterprise system (Wang, Tomasic 1994). It allowed SOE's to transform into limited-liabilities company or joint-stock company that could be listed at one

of China's two emerging stock exchanges. Although the first results were mixed (management often operated within the same *de facto* rules as before), Nee (2004) argues that it was the primary institutional foundation of Chinese state capitalism.

2. China vs. Eastern Europe

China's evolution stands in a bright contrast with economic history of East European countries. Kornai (1986) noticed that command economies have built-in tendency of becoming shortage economies and, in the long run, as a sub-optimal system cannot be sustained unless the Communist Party (that had imposed the system) maintains its political monopoly. But even in the most oppressive system, allocative distortions of central planning extort reforms or lead to emergence of 'shadow economy' outside of bureaucratic interventions. At the end of 1960s Soviet Union has significantly relaxed its collective farming, what led to higher agricultural production in a short-term, but failed to ignite long-term economic and institutional changes. In 1970s, in Hungary and, to a lesser extent, in Poland, new spaces of capitalism emerged in the shadow of planned economy. Although some petty socialist bourgeoisie has appeared at that time, there was no sign of massive accumulation of private capital (King, Szelenyi 2005: 208). At the same time, both communist governments started industrial reforms that were supposed to improve state sector efficiency. SOEs were granted significant autonomy and the central planning was replaced by partial market-type control. But all of these reforms failed. As Kornai (1986) noticed, the problem was not in the lack of financial incentives, but rather in specific relationship between the government and the companies that led to bargaining and softening budget constraints. This leads us to very important question – why micro-level forces and partial reforms have been essential and effective in transforming Chinese economy, while in other cases they did not work? Scholars provide many, sometimes contradictory answers for China's evolution. However, I will concentrate on three of them: endowment, market preserving federalism, and marketization. Taken separately, these explanations are relevant, but have some vulnerable points; together they provide a coherent picture of China's successful reforms.

2.1. Endowment

At the outset of reforms China was an impoverished agrarian economy. According to World Bank data in 1980 about 70% of the workforce was employed in agriculture and real GDP per capita was more than 20 times lower than in Hungary. Despite creation of significant heavy industrial capacity during the Mao era, China's industrialisation was far from completed. This brightly contrasted with organisation of most of East European economies, which at that time were significantly overindustrialized. As King and Szelenyi (2005) argue, misallocation of resources pushed production in all command economies deep inside the production possibility frontier, but only China's endowment allowed for transition to capitalism in a more traditional pattern. Introduction of basic market forces has ignited rural-urban migration and capital accumulation, whereas in Eastern Europe it inevitably led to destruction of some existing assets (Sachs 1995). Thanks to structural differences, China could also escape the trap insightfully described by Morawski (2001), in which subsidised workers (social force) restrain system's evolution.

All of the communist systems have been ideologically biased toward the working class, especially the part employed in heavy industry. With the evolution of the system, workers organized in the biggest industrial centres have found effective ways of extorting their will on both the Party and the economy. Levels of their social welfare guarantees were higher than average per capita income would suggest, and, like every privilege, were fiercely defended. When SOE's in Poland and Hungary were granted partial autonomy, this socio-political gridlock turned into continual bargaining between workers, management and the government. Softening of budget constraints undermined the incentives that were designed to introduce rational decisions to state-owned level. In this case China was different. Although early reforms of the state urban sector proved less effectual than bottom-up alignments affecting rural economy, they have been gradually transforming SOEs into more efficient companies. Paradoxically, China's industrial workers were relatively more privileged than their East European counterparts⁵, but as the structural argument suggests they did not have similar bargaining position. Not only were they in a clear minority as a group, but also were significantly less organised than workers in Poland or Hungary.

⁵ In East European countries the governments had established universal social welfare for all the citizens, whereas in China, the same system was never extended into the rural areas.

China's characteristic at the beginning of transformation definitely had a lasting impact on the system's trajectory. However, it is wrong to assume that it can explain the whole story. First, success of partial reforms might be determined by its institutional design rather than favourable economic structure. For example, in the late 1980's Soviet Union tried to introduce more freedom to state-owned companies by copying Chinese dual-track model. These reforms have completely failed, but as Murphy, Shleifer and Vishny (1992) showed it was the coordination failure resulting from lack of enforcement in delivering the fixed quotas that toppled the Soviet state enterprises, rather than initial structure. Second, as growth literature illustrates, underdevelopment doesn't count automatically as an asset. Influential papers of Lucas (1988) and Barro (1991) clearly show that there is no such thing as unconditional convergence in levels of per capita income and product. Easily accessible labour resources and technological backwardness matter as long as economic policy allows to draw from them.

2.2. Market-preserving Federalism

In the early 1980's China introduced fiscal decentralization aimed at strengthening economic incentives of local governments. Responsibility for many state-owned enterprises controlled on the central level was delegated to provinces, cities and townships. By 1985, share of total industrial output of SOEs controlled by the central government has decreased to 20% (Qian, Xu 1993: 165). At the same time, according to so-called fiscal-contract system, lower-level governments were to submit a fixed proportion of their revenues to the upper levels, while retaining the rest for their own expenditures (Oi 1992). Such a scheme established significant interdependence between firms' performance and government's disposable income, thus creating incentives for local bureaucrats to promote economic efficiency (Montinola, Qian, Weingast 1995). The strongest effect appeared in the rural economy on the township and village level. Operating without the access to state banking system and with small bargaining power, these governments have already been facing relatively hard budget constraints. With the implementation of the reform and the loosening of trade barriers, each townships or village found itself in competitive environment consisting of thousands of similar units. According to Walder (1995), when local government has clear profit-maximizing incentives and the ability to control subordinated enterprises, it can run them as economic corporations.

Although domination of such 'local state corporatism' in the case of TVEs is debatable (next paragraph will bring some arguments confirming their quasi-private character), there is a strong evidence of market-preserving federalism. Analysing data from successful 'corporatist' region, Peng (2001) finds that the TVEs superior performance results not from direct bureaucratic monitoring, but from indirect market monitoring. Going into more details, Cao, Qian and Weingast (1999) show that harder budget constrains resulting from revenue-sharing scheme, together with increased competition from emerging private and quasi-private sector have changed local governments' calculations for keeping SOEs and led to their privatisation.

2.3. Marketization

It is widely recognized that the motor of economic growth and institutional change were the TVEs⁶. Tens of thousands of new production facilities that were set up in the early 1980s created large and vibrant sector operating outside of the plan. Formally, they were collective rural enterprises controlled by township and village governments, but many scholars points to the difference between their *de jure* and *de facto* status. Instead of classifying TVEs as public-owned, they interpret them as a form of disguised privatisation. According to Nee (1992), such form was the second-best adaptation to the environment of underdeveloped formal institutions that provided individual actors with sufficient security for their economic actions. Reliable business norms and funding for this quasi-private sector were being developed on the basis of informal arrangements called *guanxi* (Peng, Quan 2009). As documented by Xin and Pearce (1996) in their interviews, the more market-oriented firm was, the higher was the importance of social relations⁷. Cooperation that included not only intra-market relationships, but also alliances with local Party officials became a profitable endeavour. Until the mid-1990s both TVEs and legally emerging (since 1988) private companies demonstrated similarly high operating efficiency that significantly outpaced the ratio for SOEs (Li 2005: 198–199). However,

⁶ As Zhang, Zhang and Zhao (2001) show, TVEs had the highest productivity growth among the three ownership models .

⁷ The classification was based on *de jure* status and included state-owned, collective-hybrid, and private companies. All the TVEs were included in the second group regardless of their actual status, and thus demonstrated much lower dependence on *guanxi* than private companies .

as Guthrie (1998) noted, the role of these social networks in guiding the transaction has been declining, as the state was establishing rational legal system.

A similar narration (although pointing to slightly different rationale) has been put by other scholars. According to Huang (2008), many private entrepreneurs deliberately put the 'red-cap' to imitate collective firms in order to avoid political discrimination against private ownership. Their gains included not only more favourable tax rates, but also possibility of expansion beyond restrictions imposed by the state. As a legal and political environment for private firms improved, there has been a clear trend toward privatization of TVEs since the mid-1990s. Its unique feature was that the shares were sold almost exclusively to management rather than people from outside of TVE (Li, Roselle 2003).

No matter which reason was dominating, both approaches point to a strictly market-driven character of Chinese transition. The key to success was a change in relative power of political and economic actors resulting from partial erosion of old administrative system (Rawski 1999: 142). This shift triggered gradual withdrawal of the state from direct interventions in micro-management of the economy and created incentives for economic actors to look for business opportunities, innovate, and finally break the state industrial monopoly (Nee, Oppen 2010). Correspondingly, the dominance of centrally imposed rules led to a failure of partial reforms in Eastern Europe. Even at their highest point, shadow market economy was controlled by the state and strictly limited to the sphere of consumption. At the same time, efforts to establish some market incentives at the state-owned enterprise level failed because of continuing bureaucratic dependence.

While market transition theory explains much of the successful institutional transition in China, it leaves some room for critique. First, it reduces the role of the state to merely a regulator, while there are many examples of the Chinese government acting as an important developmental force. These include not only pursuing export-promoting strategy or creating worldwide competitive national champions (Lin 2012), but also generating institutional innovations by use of trial and error approach (Naughton 1995). Contrasting growth of China's non-state industry – with unsuccessful attempts to introduce market incentives in pre-1990 Poland and Hungary, Gelb, Jefferson and Singh (1993: 101) argue that the former 'involved a far stronger commitment (of the government) to marketization and domestic competition'. Second, the market transition theory downplays the significance of political cadres' interest in realignment of economic power. In his early papers concerning Chinese marketization, Nee (1989) stressed that reforms diminished the role of redistributions and benefited the group of emerging capitalists only. But as

Walder (1995) showed, transition created new opportunities for political actors to act as regulators, brokers or even managers. This clearly suggests that the role of the state in the emergence of Chinese capitalism deserves much greater attention.

3. State Capitalism

In his seminal work, Polanyi [(1944) 2011] identified market and state as two inseparable pillars of modern capitalism, in which the later shapes incentives for entrepreneurship and capital accumulation and creates institutional architecture. As he argued, even the systems considered as bright examples of liberal capitalism had established free market under 'continuous, centrally organized and controlled interventionism' [Polanyi (1944) 2001: 146]. The idea of active role of the state during industrialisation period was further extended by Gerschenkron (1962). Because the amount of capital owned by individuals in a relatively backward economy was insufficient to move quickly into the technology frontier, the state was required not only to construct the market, but also to act as a big entrepreneur itself. The most successful examples of such capitalist developmental states were East Asian countries. By pursuing consistent catch-up strategy, Japan and its followers – newly industrialised economies (NIEs) – quickly moved up the industrial ladder and wealth rankings (Lin, Monga 2010). At first sight, China's model of economic and institutional development shares some key features with other East Asian countries, especially those that built their variety of capitalism on an authoritarian national leadership (Wade 1990; Fligstein, Zhang 2011). However, just like organisational development of Japan, Korea and Taiwan followed different paths shaped by pre-existing patterns of domination, similar mechanism explains China's structural exceptionalism. Given much bigger historical role of the state and the prevalence of authority of the Communist Party, there could be no surprise that changes of economic institutions were heavily influenced by vested interests of the state and political actors.

Krug and Hendrischke (2008) describe the Chinese transformation as a co-evolutionary process that resulted from a paradoxical duality of functions of economic actors, which made them recipients and contributors of change at the same time. This idea draws strongly from conceptual framework of new institutional economics, which presents economy as 'an evolving, open system in historical time,

subject to processes of cumulative causation' (Hodgson 1994: 69). Thus, rather than being solely determined by market forces, China's institutional development reflected a compromise between competing interests of emerging and retreating authority – market and state respectively. As Zhou (2000: 1140) argue, in some areas they mutually reinforced each other; in other, they constrained each other; but there were also some areas in which they adapted to each other to create a balanced institutional solution. Despite defiance of Party's conservative elements, the government was following the dynamic socio-economical changes by building legitimacy for economic reforms and implementing market-preserving policies. At the same time, it experimented with new market-oriented institutions like dual-track, and decided to break the state monopoly in trade by encouraging foreign direct investment (FDI) to the newly established Special Economic Zones (SEZs). Increasing contribution from non-state sector provided positive feedback for government (both on local and central level) to continue reforming and opening up (*gaige kaifang*). However, this flexible approach had its own limits: changes were supposed not to undermine the Chinese Communist Party's monopoly on political power. An obvious example of government's action to preserve its interests was a brutal crackdown of Tiananmen protests. However, there were also other measures of political upper-hand manifested in the maintenance of household registration system, corporatisation and persistence of political actors in the economic life. All of these features define the present variety of Chinese capitalism and will be discussed in the next section in more detail.

3.1. Household Registration System

One of the most important instruments of communist-led industrialisation was household registration (*hukou*) system that segregated rural and urban population in geographical, socioeconomic and political terms. The system introduced during the 1950s was heavily biased against peasants – not only it restricted their mobility, but also excluded them from redistribution of state-provided goods and services (Cheng, Selden 1994). Although data on China's income inequality measured by Gini index in the late 1970s pointed to very egalitarian society (Wang 2008: 5), in reality, there was a heavy polarisation of welfare resulting from differences in *hukou*-related entitlements. When the government gave the signal for reforms, long-suppressed rural dwellers responded *en masse* to policy relaxation by adopting basic market institutions. This brought dramatic improvement in productivity of agricultural

sector, but also deepened an already huge pool of superfluous rural labor. In that case, the natural economic mechanism would dictate rural to urban migration, but that was strongly against Party's interest of maintaining social stability. Open inflow of low-cost labor would dramatically increase wage pressure on long-time protected urban workers and, as Harris-Todaro model suggests, it would create overcrowding and significant unemployment in the cities (Harris, Todaro 1970). Until mid-1980s, the government strongly discouraged poor farmers to leave their localities⁸, what allowed for slow restructuring of SOEs, while keeping much of the urban redistribution intact⁹. State's policy toward internal migration became more flexible when the first experiments with Special Economic Zones (followed by the opening of 14 major coastal cities to foreign investment) established 'pockets' of labor-intensive industry. By mid-1990s, the so called 'floating population' became the backbone of the Chinese export industry. In the most extreme case of the city of Shenzhen, the number of temporary migrants increased from 1,5 thousand in 1979 (0,48% of then local population) to 2,5 millions in 1994 (72% of then local population) (Liang 1999: 123). With the economy growing, many local governments conditionally opened urban residency to rural people in order to provide low-end services for city dwellers. However, stringent measures were re-introduced every time the officials felt an increased pressure from growing urban unemployment, especially when the SOEs reforms moved into the phase of privatisation (Chan 2010: 71). In the course of time, *hukou* system has gradually lost its importance as a tool controlling labor movements. According to official statistics, in the first quarter of 2012 the number of rural migrant workers amounted to 163,7 million people (National Bureau of Statistics of China 2012). Nevertheless, despite all the reforms, essential features of the pre-existing stratification order remained actually unchanged. Rural migrants that do not have urban *hukou* are still denied access to many social entitlements enjoyed by other urban residents: health care, housing and higher education. As an effect of *hukou* restrictions, huge pool of workforce has been trapped in low-end and low-productivity activities.

Looking from the market economy perspective, the persistence of heavy distortions on the labor market would inevitably lead to inefficiencies. However,

⁸ With implementation of *litu bulixiang* policy (leaving agriculture without leaving the village), peasants were encouraged to stop farming and work in local TVEs, but were not allowed to move to other places.

⁹ Under the dual-track strategy mandatory output guaranteed status quo rents of industrial workers, while above-the-plan production was responsible for introduction of market incentives and gradual rationalisation.

by keeping unproductive institutional arrangement the Communist Party played its own interests that differed from the interests of rational economic agents. First, the *hukou* system, together with financial restrictions and exchange rate policy, allowed the state to retain significant control over the composition of the economic growth. All of the before-mentioned arrangements should be seen as an implicit tax that transfers income from households to enterprises (of which many were state-owned) and to the state itself. In effect, the leadership was pursuing a policy that hindered individual consumption but promoted state-guided investment. Secondly, although the maintenance of household registration system led to a gradual increase in inequalities between rural and urban population, it paradoxically reduced the risk of social instability that could threaten the Party's political monopoly. As Ping and Pieke (2003) suggest the government believed that the rural population gained sufficiently from the de-collectivisation of agriculture and early reforms that established TVEs. Even if more economic freedom has brought demands for participation in public welfare, peasants lived in fragmented communities and this limited the scale of collective actions. In terms of political stability, it was the voice of urban population that counted. Because neither central government, nor local authorities had the resources to extend significantly entitlements to migrant families, changes in stratification order could not be made without concessions from cities' residents. Fearing their resistance, authorities easily sacrificed potential gains from flexible labor market for social stability. Although foreign media inform about riots that are caused by peasants or migrant workers, so far the calculation of the Communist Party has been working well. Citing Whyte's study 'Myth of the Social Volcano: Perceptions of Inequality and Distributive Injustice in Contemporary China', *The Economist* ('Money can't buy me love') presents clearly that rising income gaps are not the main, nor even the primary source of popular discontent in China. However, if the persistent polarisation is not addressed, the balance of dissatisfaction may change.

The foundation of *hukou* system can be shaken not only on social but also on economic ground. China's strategy of becoming the 'world's factory' has been relying on low-cost migrant workers who have kept the export industry internationally competitive for a long time. But if not accompanied by moving up the value chain, sooner or later such growth strategy has to 'hit the glass ceiling'. During its developmental phase none of the East Asian tigers has formally implemented internal migration control. As many researchers suggest, both South Korea's (Park 2009) and Taiwan's (Speare 1974) export-oriented industrialisation benefited significantly – in extraordinary rapid urbanization and crucial knowledge spillovers – from flexible

reallocation of labor. With the *hukou* impediments that lead to suppression of social capital and inefficiencies in workforce allocation, China might find it hard to escape the middle-income trap.

3.2. State as a Corporation

As presented by Schmidt (2002), not only during the developmental stage but also in many advanced capitalist countries the state plays (to a varying degree) the role of capitalist, as it owns or manages some of the corporations. The logic behind this involvement is the existence of sectors vital for state's functioning including defence industry, infrastructure, or some environmentally essential resources. However, in some varieties of capitalism state's control extends to much bigger part of the economy, as the government tries to promote growth by picking winners and investing in research and development¹⁰. This expansion combines some market asymmetry in favour of state-owned or affiliated enterprises with classical capitalist tools like corporate governance, listing on the stock exchange and international expansion. China is a very special case of such state capitalism.

Over the past three decades the Chinese state has been officially retreating from the economy. According to World Bank (2012: 110), throughout the period 1998-2012 the share of public sector in the total number of industrial enterprises (with annual sales over 5mn RMB) fell from 39,2% to 4,5%, from 68,8% to 42,4% in the total industrial assets, and from 60,5% to 19,4% in employment¹¹. However, as more than two-thirds of Chinese companies listed in the Global Fortune 500¹² are state-owned, and about 80% of capitalisation on national stock exchange was made up in 2007 by SOEs (OECD 2009), it is hard to dismiss the role of the state in the economy. After the large-scale privatisation in the late 1990's under the principle *zhuada fangxiao* ('grasping the big, releasing the small'), the government focused on several key

¹⁰ There are also cases in which state monopolises part of the economy in order to provide extended social safety net (e.g. Germany and Scandinavian countries). However, they should be excluded from the model of state capitalism, as this additional activity rarely goes beyond the provision of welfare arrangements.

¹¹ When look closer at the data, it becomes clear that SOEs consume much larger proportion of resources than firms from the private sector to produce relatively small share of output.

¹² In the ranking for 2011 there was 61 Chinese corporations listed in the top 500, see: <http://money.cnn.com/magazines/fortune/global500/2011/>

sectors to promote national champions. First, it chose strategic industries where a handful of SOEs could compete with each other but which were highly protected from new entries by formal and informal barriers. Second, it identified the so called 'pillar' industries where it expected to retain a strong influence¹³. As an effect, in most of the upstream industries SOEs were granted a *de facto* monopoly, while the downstream industries like factory-assembled exports, clothing and food became open to intensive competition between private firms.

As discussed earlier, during the reforms many SOEs were corporatized and radically restructured. At the same time, government became a more sophisticated owner when it transferred the authority of policy making, oversight and asset management to the established in 2003 central holding company known as the State-Owned Assets Supervision and Administration Commission (SASAC). This move can also be seen as the milestone in the creation of formal business groups, which, in Granovetter's (2005: 429) definition, are 'sets of legally separate firms bound together in persistent formal and/or informal ways'. As Keister (1998: 405) pointed out in her analysis of groups' formation, the government drew heavily from the example of Japan's *keiretsu* and Korea's *chaebol*. Like their East Asian counterparts, first Chinese business groups (*qiye jituan*) emerging in the late 1980s have been characterised by complicated interfirm relations that included not only financial and trade ties, but also interlocking management. However, just like the Japanese conglomerates differed in many aspects from the Korean ones, Chinese groups have a very distinctive path of formation. It is marked by much heavier influence of state and much lower role of social relations (at least in the very early stage of group's emergence). At the beginning of reforms, China's economy was deprived of private ownership and business relations that did not result from the fulfilment of the plan. Groups could not emerge from elite, wealthy families as it was in Korea, or on the base of previously existing conglomerates (*zaibatsu*) as was the case of Japan. Instead, they were assembled by political authorities from the state-owned companies, only to be joined by some successful private companies later. However, even these few non-state business groups that emerged in the sectors defined as non-strategic were somehow related to state institutions or governmental cadres¹⁴.

¹³ Strategic industries included: defense, generation and distribution of electricity, petroleum and petrochemicals, telecommunications, coal, civil aviation, waterway transport; 'pillar' industries included: automobiles, machinery, steel, base metals, chemicals, construction, electronics and IT.

¹⁴ First, when the government set off the privatisation, managers of many SOEs were able to buy their firm out (often at low prices) and establish private group with other enterprises that have just

Organisation of China's state controlled business groups has evolved, as the government was trying to find an optimal control-performance balance. Early experimentation with different set-ups created large and diversified multi-industry conglomerates. As reforms proceeded, groups have been focusing on their main activity and gradually converging to a typical organisational structure with a dominant entity (wholly owned by SASAC), financial company (functionally similar to the main bank in Japanese *keiretsu*) and one or more publicly traded subsidiaries. Although many national champions were allowed to make initial public offerings on the foreign stock exchanges, they remained closely tied to the majority shareholder, i.e. state, by means of corporate governance¹⁵. In fact, the structure of conglomerates took heavy hierarchical form, with the mother-SOE coordinating group's activity and transferring policy of the state downstream. Drawing from Lin (2010), two main bureaucratic channels of coordination can be identified. The first one is personnel policy that allows the government to appoint SOEs' management team and to transfer corporate executives between different organisations. Having such a powerful tool, the Communist Party can choose its favourite candidates at the beginning of the process, and support them during their later career. This leads to a situation where managers are promoting Party's rather than company's interests. The second bureaucratic channel of coordination is financial mechanism resulting from near monopoly of political elites in the domestic capital market. Because the state controls all the major banks in the country and runs the largest sovereign-wealth funds in the world ('New masters of the universe', *The Economist*), it can easily allocate capital for preferred investment projects. In their detailed paper, Dobson and Kashyap (2006) document commanded credit policy and underservicing of non-state-owned corporate borrowers by state controlled banks, what had its side effect in the surge of non-performing loans. According to the report prepared by World Bank (2010: 118), during last years the state not only consolidated its position in strategic sectors, but also expanded to many competitive industries such as wholesale trade, retailing and restaurants. Furthermore, it significantly increased its patronage to formally private

been privatised. Second, owners of some of the most successful China's firms – like Lenovo, Huawei, or Haier – are reported to be former academics, or local Party officers.

¹⁵ Even though they pointed to many state inflicted distortions, Nee, Opper and Wong (2007) argue that corporatisation and listing of companies improved their monitoring and performance. Yet Clarke (2011: 102) mentions that *de facto* corporate governance practices in China remain very different from the companies' statute books.

groups that became winners on the domestic market (in more technically advanced industries), and now can be supported in a global competition¹⁶.

When looking at China's state-biased corporate system from the perspective of political elite's interest, there are several system's advantages that are hard to dismiss. Obviously, the control over a huge pool of resources gives Party's members and protégés several pecuniary and non-pecuniary benefits. Yet, by now, the state corporatism has also worked well on the field of maintaining social stability. Having direct access to SOEs' profits, the state is able to make heavy investment in targeted areas that are vital for economic growth (like education and infrastructure), or for the reduction of regional disparities (like the 'Opening Up the West' campaign). To some point, this surplus capacity allows the government to smooth the economic cycle, as temporary induced investment may replace a faltering global or domestic demand. Additionally, as argued by White, Hoskisson, Yiu and Bruton (2008), the existence of state-owned business groups facilitates institutional transition, because it helps to balance conflicting pressures: the market pressure for innovation with the workers' pressure for employment.

However, the number of distortions that this system produces raises the question about the profitability of SOEs and the sustainability of existing corporate framework. Hsieh and Klenow (2009) argue that resource misallocation in Chinese manufacturing sector depresses its aggregate total factor productivity (TFP) by 30%–50% when compared to United States. Although they suggest many different reasons for these inefficiencies, the state-guided reallocation of capital might have been the primary one. In a similar manner, surveying more than 12 thousand randomly chosen firm, Dollar and Wei (2007) find that China could account for the same growth with 5 percent of GDP lower investment intensity, if only it succeeded in more efficient capital allocation. The latest data provided by the World Bank (2012: 111) shows that the average return on equity of Chinese state-owned firms in 2009 was by almost 10 percentage points lower than that of non-state companies¹⁷. However, as reported in this publication, in the period of 1998–2007 underperformance of SOEs has slightly decreased. Arguably, this was the result of their restructuring, introduction

¹⁶ For example, acquisition of Volvo by private Chinese carmaker Zhejiang Geely Holding Group was predominantly financed by local governments in northeast China and the Shanghai area (Wines 2010).

¹⁷ This gap could be even bigger if one accounted for significantly higher cost of debt for non-state firms and artificially high rates of return of SOEs in the sectors where state has the monopoly. On the other side, some SOEs performance might be depressed by regulated prices and responsibility for delivering public services.

of corporate governance and increased domestic and international competition¹⁸, but Li, Liu and Wang (2008) present a somehow less favourable explanation. According to their provoking analysis, growing prosperity of SOEs is 'merely an undesirable symptom of the gradualism and incompleteness of reform' (Li, Liu, Wang 2008: 8), that is persistence of state monopoly in key sectors of the economy.

3.3. Persistence of Political Actors

The classical bureaucratic channel of intervention is just one of two important ways the state influences the economy. The other, distinctive for China's variety of capitalism, is the participation of Communist Party members in the decision making on the firm level. Contrary to the ownership rights, this channel provides disguised control over micromanagement and extends way beyond the official presence of the state. The basic tool for 'shadow commanding' are Party cells operating in state-owned companies. Despite the introduction of corporate governance with some classic institutions like board of directors and shareholder's meeting, the old political organs have not been abolished. Moreover, new cells are being set up in private companies. According to *The Economist* ('Where's the party?'), between 1999 and 2011 the share of private firms with the Party's organ incorporated into their structure grew from 3% to 13%.

The persistence of political actors in economic life takes also the form of networking, or more precisely, manifests itself in the importance of political connections. Despite finding sectors where political capital is of small importance, Nee and Oppen (2007) argue that the economic success of Chinese company is highly affected by its relations with state representatives and call this framework a 'politicized capitalism'. Since the late 1980s, many from the former *nomenklatura* quit their government positions to join the ranks of private sector. This phenomenon, known later as *xiaohai* ('jumping into the sea'), became very popular among the Party officials when the reformatory approach to China's economy has been re-confirmed. In a single year of 1992 more than 120 thousand Party members got directly involved into the business (Wu, Xie 2002: 8, *supra* note 3), while many others hedged their

¹⁸ According to this point of view, growing share of private firms induces higher pressure on state-owned companies (despite heavy 'administrative monopoly'). At the same time, China's entry to WTO in 2001 expanded the scope of international competition.

bets by promoting relatives¹⁹. The second wave of officials engaging in business took place in late 1990s with the privatisation of SOEs. According to a detailed study of 790 companies that went public in China in the period 1993–2001, almost 27% of newly acting CEOs were politically connected (Fan, Wong, Zhang 2007: 331)²⁰.

The relationship between the Party and the market has also been inspired by the latter. First, many private entrepreneurs, especially those operating in more regulated industries, tried to establish close personal ties with the local political elite. At one extreme, the businessmen invited officials into consulting bodies that were set up to provide guidance to decisions strategic for the firm²¹. Moreover, a growing number of private owners started to apply for Party membership. Based on a survey conducted between 1997 and 1999, Dickson reports that 40 percent of large and medium scale entrepreneurs were already Party members, while the same ratio in the total population amounted to only 5 percent (Dickson 2003: 111). Having overcome strong ideological resistance, in the early 2000s the Party changed its strategy toward capitalists – instead of only tolerating them, it started to court them actively under the new ‘Three Represents’ ideology. This move provided the state with discretionary control over the growing private sector, but also gave the co-opted entrepreneurs information advantages and access to scarce resources (most notably credit) or government contracts. According to Li, Meng, Zhang (2006), the probability of entering politics was strictly related to the shape of local institutions – weaker legal protection and lower scope of marketization induced higher participation of entrepreneurs in the Party. These results bring forward a striking feature of China’s emerging capitalism: business structure based on political connections was a natural adaptation to a more hostile institutional environment.

The persistence of political actors in the economy has blurred the market-state boundary and created a system based on unproductive rent-seeking. Besides the share of politically connected CEOs, the already cited study tries to quantify the economic effect of Party’s influence. It appears that companies managed by politically connected CEOs had by almost 18 percent lower stock returns (in the first three years after initial public offering) compared to outsiders (Fan, Wong, Zhang 2007). One

¹⁹ Here, the offspring of prominent senior communists – so called ‘princelings’ – became especially influential.

²⁰ Which means they were currently affiliated with a government agency or were former bureaucrats (Fan, Wong, Zhang 2007: 331).

²¹ See for example Wank (1999), who documents how private entrepreneurs in Xiamen had to cultivate patron-client networks with local officials in order to boost profits and security.

of the fiercest critics of the China's variety of capitalism argue that local officials have effectively privatized the state authority and introduced widespread corruption to economy (Pei 2006). The mounting examples of 'princelings' managing biggest Chinese transnational corporations (Ding 2000: 122) and accumulating vast amount of wealth (Barboza, LaFraniere, "Princelings' in China Use Family Ties to Gain Riches') provide clear evidence of political opportunism. However, the relation between the *nomenklatura* and the market cannot be judged one-sidedly. To look for a positive perspective one has to turn to Olson's (1982) analysis of special interest groups. When the privileged group has both the incentives and the political power, it can block the formation of institutions that are economically productive, but run counter to group's interest. In the case of China, it was the growth of market economy that threatened the pre-reform position of the Party. Arguably, once the China's political actors started to benefit from the market, they naturally became more interested in efficiency and economic growth. This approach is confirmed by some researches. Li (1998), for example, presents *xiaohai* as a force which pushed for market-oriented changes in the Chinese bureaucracy by making officials more interested in expansion of private sector. Yet, the growing share of the market economy has gradually reversed this positive balance. Having established a foothold in the non-state sector, politically connected actors had clear incentives to use their positional power to maintain the system's asymmetry. This time, the interests of the privileged group run counter to the interests of the market, leading to emergence of crony capitalism.

4. Discussion – is China's Variety of Capitalism Nash-like Equilibrium?

During last three decades China's economic system has undergone a great transformation from communism to some form of state-led capitalism, in which 'the state' means actually 'the Communist Party'. With the collapse of Maoist economy, the legitimacy of the Party has been tied to its ability to deliver improvement in people's living standards. The success of early reforms (many of which originated spontaneously counter to the Party's official standpoint) has build a strong pro-reform camp and reinforced the leadership's commitment to further changes. The

evolutionary approach that balanced the interests of economic and political actors led to growth of subsidiary markets around the state-planned economy, introduced the SOE's to harder budget constraints, and finally eroded the socialist ideas of communal solidarity. Yet, the market-oriented reforms have only partially reduced the Party's 'rule and divide' approach to the economy. Much of the former direct control has been replaced by more discretionary measures like corporate governance, which conserved the extensive patronage system, and Party affiliation, which allowed for political penetration of the private sector.

According to the socio-economic literature, the long-term performance of the economy is determined by its specific institutional framework and specific organisation of relations between the main actors. Comparing the average rates of growth of GDP in the last decade, it seems like China's transformation has produced system that strongly supports economic development. Since joining the World Trade Organisation (WTO) in 2001, country's output (measured in constant prices) has increased on average by 9,7% annually²² – the rate surpassing the past growth rates of other East Asian countries. However, when look closer at fundamentals, it becomes clear that China's variety of capitalism intensifies not only advantages but also the failures of Asian developmental state²³. First, existing model of growth has been relying on the financial repressions that have channelled the gains of growth from the society to the state²⁴. Undervalued currency, negative rates of return for depositors, and state-biased credit policy have secured the capital for state-guided investment by depressing the wealth of China's citizens. With the investment rate reaching almost 50% of GDP, there is a growing fear of massive misallocation of capital leading to severe financial crisis. At the same time, in the pursuit of double-digit growth rates, the government has neglected the distributive aspect of the development. Although the 11th five-year plan for 2006–2011 called for creation of 'harmonious society' (*hexie shehui*), the main social concerns: growing inequalities, lack of social protection and environmental deterioration were hardly addressed.

Another system's failure is triggered by the persistence of the state at the corporate level. Trying to maintain its influence by appointing loyal managers, the Party risks

²² Calculation based on: International Monetary Fund, World Economic Outlook Database, April 2012, ratio: *Gross domestic product, constant prices*.

²³ For critique of the Asian developmental state, see for example Wong (2004).

²⁴ As presented by Reinhart, Kirkegaard and Sbranca (2011: 22) 'financial repression occurs when governments implement policies to channel to themselves funds that in a deregulated market environment would go elsewhere'.

creating ground for rent-seeking on the part of protégés. In such a framework, the agency cost (resulting from the principle-agent problem) is a price the state has to pay for control over the economy. Moreover, authoritarian rules that lack the 'checks and balances' mechanism are prone to widespread corruptions, as political actors are tempted to cash in on their unlimited positional power. According to Acemoglu and Robinson (2012), the 'extractive' institutions that put the interests of the elite over the those of the society will gradually restrain China's growth. The lasting stagnation of the Japanese economy and the severity of Asian financial crisis in South Korea (that resulted in the collapse of several *chaebols*) have demonstrated that the state-led development model degenerates over time into unproductive configuration (Evans 1997). Although inefficiencies of similar magnitude (but of different origin) have been found in liberal market economies, the state capitalism guided by authoritarian political forces provides less correcting mechanisms.

As every economy is embedded in and constrained by the specific social relations and historical path of change, the classic Anglo-American model may not be the best, or even feasible response for China's problems. However, in the light of mounting economic waste, further development of the most populous country will strictly depend on withdrawal of the political actors from the economy. The present China's variety of capitalism is hardly an optimal solution.

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