From Mao to Market

Rent Seeking, Local Protectionism, and Marketization in China

ANDREW H. WEDEMAN
University of Nebraska, Lincoln

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The Pitfalls of Reform

AN examination of China's economic performance since 1970 reveals a stark divergence from those of other socialist economies. Although growth rates in China paralleled growth rates elsewhere during the 1970s, in the 1980s the Chinese economy entered a period of accelerating growth while the other economies stagnated (see Fig. 1). After 1989, the economies of the successor states to the Soviet Union and in the former Eastern bloc contracted rapidly, while the Chinese economy continued to grow rapidly. By the late 1990s, the economies of the ex-communist states had generally stabilized. In most cases, however, these economies were only marginally larger in 2000 than they had been twenty years earlier. The Chinese economy, on the other hand, was some seven times larger than it had been two decades earlier.

The great divergence of the Chinese economy from those of the Soviet Union and Eastern Europe is surprising. First, previous attempts at limited reform had generally failed. Second, and more significant, China embraced what neoclassical economists deem the "wrong" reform strategy (slow incremental reform) rather than the "right" reform strategy (rapid, comprehensive reform).[1] According to the existing literature, China's paradoxical success with incremental reform can be explained in two different ways. On the one hand, "big bang" theorists argue that China's success was neither paradoxical nor contrary to neoclassical orthodoxy but rather the result of prior conditions. Proponents of the "evolutionary" school, on the other hand, argue that China did not adopt a "wrong" reform strategy and contend that incrementalism was actually a

[1] It bears noting that Vietnam, which adopted a Chinese-style program of incremental reforms, has also experienced strong economic growth. See Martha de Melo and Alan Gelb, "A Comparative Analysis of Twenty-Eight Transition Economies in Europe and Asia," *Post-Soviet Geography and Economics* 37, no. 5 (May 1996): 265 and David Dollar, "Macroeconomic Management and the Transition to the Market in Vietnam," *Journal of Comparative Economics* 18, no. 3 (June 1994): 357–75.

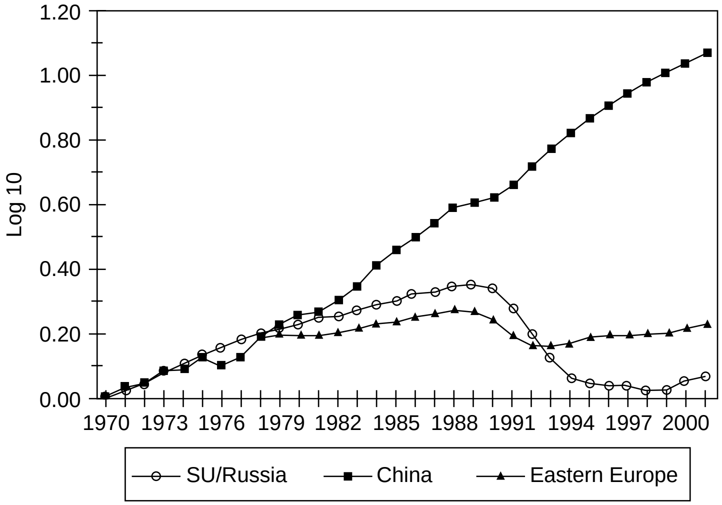

Figure 1-1. Growth in GNP.
Sources: World Bank, *World Tables 1995* and *World Development Indicators*. Figure represents an index of growth in gross domestic product, where 1970 = 1. Indices logged to highlight the divergent trends.

superior strategy because it allowed the Chinese economy to move from one system to another without first destroying the old system and then building an entirely new system on the rubble of the old. In this book, I will show that while both the big bang and evolutionary schools are not without considerable merit, each only partially explain why China managed to make the transition from the Maoist planned economy to an essentially market-based economy.

Neither the big bang nor the evolutionary models explain, however, why China did not become entrapped in the same "pitfalls" that ensnared the post-Soviet states. Students of the post-communist transitions in Eastern Europe and the former Soviet Union maintain that attempts to reform a socialist economy are likely to degenerate into "oligarchic capitalism" characterized by rent seeking,[2] corruption, and "crony capitalism" and stall out halfway

[2] As used herein, a rent is an artificially created profit that exceeds the profit obtained absent some exogenous manipulation of market conditions. Rent seeking is thus defined as activities designed to create either inflated profits or to gain control over rents previously created by artificial intervention. See Jagdish Bhagwati, "Lobbying and Welfare," *Journal of Public Economics* 14 (1980): 1069–87; Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 65 (June 1974): 291–303; James Buchanan, "Rent Seeking and Profit Seeking," in James Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station, TX: Texas A & M Press, 1980): 3–15; and Robert D. Tollison, "Rent Seeking: A Survey," *Kyklos* 35, no. 4 (1982): 575–602.

between the plan and the market.[3] The pervasive shortages and price rigidities characteristic of Soviet-type economies, they argue, created a complex system of rents that are scraped off by the state or by corrupt officials in the form of bribes.[4] Where partial reforms fail to eliminate these rents quickly by decontrolling prices, the first wave of reforms are likely to trigger a wave of rent seeking and corruption as insiders seek to capture rents themselves or new "entrepreneurs" attempt to grab them. Because the gains from partial reform are likely to be highly concentrated, this relatively small class of rent seekers is less vulnerable to the collective action problem than the mass of "losers." The net result is that the initial winners are likely to gain the upper hand politically, capture the state, and use their newfound political power to block further reforms that would dissipate rents.[5] In this model, once the central planning apparatus has been weakened, a partial reform program is apt to be hijacked by a coalition of the old *nomenklatura*, "red directors," and oligarchs seeking to construct a predatory form of capitalism. Unrestrained rent seeking, however, is likely to prevent such a system from stabilizing; in the end, corrupt officials and the oligarchs are likely to drive the economy to the point of collapse.[6]

[3] See Kevin M. Murphy, Andrei Shleifer, and Robert W. Vishny, "The Transition to a Market Economy: Pitfalls of Partial Reform," *The Quarterly Journal of Economics* 107, no. 3 (August 1992): 889–906; Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50, no. 2 (January 1998): 203–34; Anders Aslund, "Why Has Russia's Economic Transformation Been So Arduous?" Paper presented at the World Bank's Annual Conference on Development Economics, Washington, DC, April 1999 (available at http://www.ceip.org); Anders Aslund and Peter Boone, "How to Stabilize: Lessons from Post-Communist Countries," *Brookings Papers on Economic Activity*, no. 1 (1996): 217–314; Oleh Havrlyshyn and John Odling-Smee, "Political Economy of Stalled Reforms," *Finance & Development* 37, no. 3 (September 2000); and de Melo and Gelb, "A Comparative Analysis of Twenty-Eight Transition Economies in Europe and Asia": 265–85.

[4] See J.M. Montias and Susan Rose-Ackerman, "Corruption in a Soviet-Type Economy: Theoretical Considerations," in Steven Rosefielde, ed., *Economic Welfare and the Economics of Soviet Socialism: Essays in Honor of Abram Bergson* (New York: Cambridge University Press, 1981): 53–83; Gary M. Anderson and Peter J. Boettke, "Soviet Venality: A Rent-Seeking Model of the Communist State," *Public Choice* 93, no. 1–2 (October 1997): 37–53; and Andrei Shleifer and Robert Vishny, "Pervasive Shortages under Socialism," *Rand Journal of Economics* 23, no. 2 (Summer 1992): 237–46. Also see Andrei Shleifer and Robert W. Vishny, *The Grabbing Hand: Government Pathologies and Their Cures* (Cambridge, MA: Harvard University Press, 1998).

[5] Joel Hellman and Mark Schankerman, "Intervention, Corruption and Capture: The Nexus between Enterprises and the State," *Economics of Transition* 8, no. 3 (November 2000): 545–76 and Thane Gustafson, *Capitalism Russian-Style* (New York: Cambridge University Press, 1999): 14.

[6] Anders Aslund and Mikhail Dmitriev, "Economic Reform versus Rent Seeking," in Anders Aslund and Martha Brill Olcott, eds., *Russia after Communism* (Washington, DC: Carnegie Endowment for International Peace, 1990).

Big bang reforms that quickly eliminate controls on prices and allow for rapid privatization, on the other hand, are likely to create economic chaos in the short term. Given an initial condition of scarcity, rapid reform will trigger inflation and windfall profits (rents) for those in control of scarce goods. Inflation and rents should, however, lead to a rapid increase in production by attracting new entrants. After a period of chaos, rents should dissipate and the economy should begin to expand rapidly. The rapidity with which the reforms and an accompanying dramatic decrease in the ability of state agencies should also prevent rent seekers from "capturing" the state and perverting the "reform" process into one that prevents the elimination of most rents.

Reforms that focus purely on transforming the economy without concurrent political reforms are also more likely to stall, according to students of the post-Soviet transitions. If the sweeping powers of the old party-state are not reduced at the same time economic reforms are introduced, cadres and state institutions will continue to be able to manipulate regulations and create rents for themselves or for private interests, as they did under the old system.[7] The resulting headlong quest for rents and loot can result in institutional implosion and, possibly, state collapse as the corrupt officials usurp the power of the state.[8] Weakening the state and reducing the ability of officials to enforce and manipulate rules and regulations arbitrarily thus reduce the threat that corrupt cadres and private rent seekers will succeed in hijacking the reform process.

In short, analyses of economic transitions in Eastern Europe and the former Soviet Union suggest that countries that adopt incremental economic reforms and remain under the control of nondemocratic regimes are more likely to evolve into degenerate economic forms. Economies that combine elements of state control with markets essentially facilitate extensive rent seeking and are more likely to bog down in this intermediate stage than those countries that marketize rapidly.

This being the case, China's reforms should have stalled somewhere between the plan and the market. Deng and his allies eschewed sweeping reforms, opting instead to move slowly, liberalizing agricultural production first and allowing new industrial sectors to grow up outside the plan. They backed away from privatizing the state sector. They also rejected price decontrols and opted instead to create a "two-track price system" that explicitly left in place rents and

[7] See Anders Aslund, "Lessons of the First Four Years of Systemic Change in Eastern Europe," *Journal of Comparative Economics* 19, no. 1 (August 1994): 22–38; Jan Winiecki, *The Distorted World of Soviet-Type Economies* (New York: Routledge, 1988); and M.S. Voslensky, *Nomenklatura: The Soviet Ruling Class* (Garden City, NY: Doubleday, 1984).

[8] Steven L. Solnick, *Stealing the State: Control and Collapse in Soviet Institutions* (Cambridge, MA: Harvard University Press, 1998).

assigned them to the state. Thus, they created an economy that they dubbed "socialism with Chinese characteristics." It was no longer socialist but was not yet capitalist, and instead stood awkwardly between the old Maoist command economy and the market. Moreover, China's reformers rejected political reforms. Instead, they implemented a program of decentralization that increased the power of local governments but failed to institutionalize legal structures that would prevent local officials from selectively applying economic regulations. Deng, in other words, did virtually everything wrong and China's semireformed economy should have faltered in the face of dysfunctional rent seeking. Yet the Chinese economic obviously prospered.

China managed to defy the odds against incrementalism in large part, according to the proponents of the big bang model, because its economy was so underdeveloped that extremely high rates of growth could be achieved given even marginal reform.[9] First, whereas the economies of Eastern Europe and the Soviet Union were largely industrialized by the 1980s and had essentially reached the feasible limits of growth under a planned economy, the Chinese economy remained under industrialized. In 1978, 71 percent of China's labor force was engaged in low value-added agriculture, with the result that this sector accounted for just 28 percent of gross domestic product (GDP), and yielded output value of just ¥360 per worker. Industry, on the other hand, accounted for 17 percent of employment but 49 percent of GDP and yielded output value of ¥2,504 per worker.[10] Because productivity per worker in the agricultural sector was lowered by the deployment of excessive labor, shifting surplus labor out of agriculture and into industry allowed for significant gains in productivity and hence quick gains in GDP.

Second, much of China's existing industrial capacity was underutilized prior to reform, creating considerable slack and hence room for rapid growth simply by increasing production. Third, even though China enjoyed a considerable comparative advantage in the cost of labor, trade accounted for only 10 percent of gross national product (GNP). Thus, significant gains could be obtained by expanding exports. Fourth, unlike the Soviet Union, where wage increases during the Gorbachev period had exceeded the growth in consumer goods, creating a "money overhang" and repressed inflation, China's low household

[9] See Hu Zuliu and Moshin S. Khan, "Why is China Growing So Fast?" *Economic Issues* 8; Jeffrey D. Sachs and Wing Thye Woo, "Understanding China's Economic Performance," Harvard Institute for International Development, Development Discussion Paper no. 575 (March 1997); Wing Thye Woo, "The Real Reasons for China's Growth," *The China Journal*, no. 41 (January 1997): 115–37; and Wing Thye Woo, "Chinese Economic Growth: Sources and Prospects," in Michel Fouquin and Françoise Lemoine, eds., *The Chinese Economy* (London: Economica, 1998).

[10] Based on data in *Zhongguo Tongji Nianjian, 1994* (Beijing: *Zhongguo Tongji Chubanshe*, 1994).

income and savings meant that inflationary pressures were low.[11] Enforced savings also meant that there was pent-up demand for consumer goods and hence a ready market for increased industrial production. The potential for growth was so strong, in fact, that even a flawed gradualist strategy would have triggered rapid gains.[12]

Several additional factors minimized the negative consequences of incrementalism, according to the believers in the big bang approach. First, although systemic reform may have unfolded in an ad hoc manner, critical reforms, such as the decollectivization of agriculture, were actually implemented in a swift, comprehensive manner and the greatest gains were realized in the areas where the most rapid and radical reforms took place.[13] Second, whereas state institutions in the former Soviet bloc either crumbled during the early days of reform or were severely weakened by reform, the center in China remained relatively strong and was able to contain rent seeking and prevent a "bank run" scramble to strip the state of all its assets.[14] Third, whereas bureaucratic interests in the former Soviet Union and Eastern bloc were deeply entrenched and had a virtual choke hold on their economies, the Chinese bureaucracy had been so battered by the twin upheavals of the Great Leap Forward and the Cultural Revolution that it was too weak to stifle reform and quickly lost its grip on the economy.[15] The big bang school thus holds that incrementalism "succeeded" in China not because it was a wise strategy but rather because the repressed economic forces were so strong that even the "wrong" strategy was likely to produce "good results."[16] China, in other words, achieved rapid growth despite Deng's incremental reforms.

[11] de Melo and Gelb, "A Comparative Analysis of Twenty-Eight Transition Economies in Europe and Asia."

[12] Sachs and Woo, "Understanding China's Economic Performance": 2–4.

[13] Jeffrey Sachs and Wing Thye Woo, "Structural Factors in the Economic Reforms of China, Eastern Europe, and the Former Soviet Union," *Economic Policy* 9, no. 18 (April 1994): 101–45 and Wing Thye Woo, "The Art of Reforming Centrally Planned Economies: Comparing China, Poland, and Russia," *Journal of Comparative Economics* 18, no. 3 (June 1994): 276–308.

[14] Murphy, Schleifer, and Vishney, "The Transition to a Market Economy": 906 and Steven L. Solnick, "The Breakdown of Hierarchies in the Soviet Union and China: A Neoinstitutional Perspective," *World Politics* 48, no. 2 (January 1996): 209–38.

[15] Woo, "The Art of Reforming Centrally Planned Economies."

[16] It is difficult to understate the big bang school's contempt for gradualism. Woo, for example, writes:

> Gradualism is not like a person putting his pants on one leg at a time and big bang with the person jumping into his pants. The more accurate picture of gradualism is a person putting one leg into the pants and then stopping for a meditative smoke because he is insecure about whether he would not be better off with a fig leaf or a loincloth instead.

Woo, "The Art of Reforming Centrally Planned Economies,": 276–308.

The mainstream "evolutionary" school in the China field itself, however, maintains that gradualism was the key to successful reform in China. Whereas reformers in Eastern Europe and the former Soviet Union sought to shift quickly from a command-based economy to a market-based economy by eliminating existing economic institutions, China's reformers sought to modify existing institutions and thereby increase overall efficiency. China's reformers, therefore, sought to stimulate growth and introduced limited market mechanisms in an instrumental and incremental fashion. Reform was designed to release underutilized resources and reallocate them to more efficient use.[17] During the early stages, this was done in a bold manner that was not necessarily different from the big-bang approach. But the scope of change was much more limited. Whereas reformers using a shock-therapy approach mounted a frontal assault on the entire economic system, reformers in China targeted specific inefficiencies with the aim of accelerating growth in selected sectors where the greatest gains in efficiency were likely to be realized: agriculture and foreign trade.[18] Policy makers approached reform with fundamentally different assumptions:

> Policy makers in Russia and Eastern Europe have behaved as if they believed that successful transition would result in sustained growth. The Chinese have reversed the direction of causality: sustained growth permits a successful transition, while falling output and incomes greatly hamper it.[19]

Because the goal of reform was growth rather than systemic change, China's reformers left intact the main elements of the old command economy and allowed them to continue to function, thus preventing a sudden drop in output. New market-driven sectors were then established alongside the command sector, not by reallocating resources from the plan sector, as would be done in a shock-therapy reform, but rather by mobilizing new resources in formerly suppressed sectors.[20] As a result, China's gradualist approach avoided the "J-curve"

[17] Richard Pomfret, "Growth and Transition: Why has China's Performance Been So Different?" *Journal of Comparative Economics* 25, no. 3 (December 1997): 422–40.

[18] Kang Chen, Gary H. Jefferson, and Inderjit Singh, "Lessons from China's Economic Reforms," *Journal of Comparative Economies* 16, no. 2 (June 1992): 201–25.

[19] Keith Griffin and Azizur Rahman Khan, "The Chinese Transition to a Market-Guided Economy: The Contrast with Russia and Eastern Europe," *Contention* 3, no. 2 (Winter 1994): 104.

[20] Justin Yifu Lin and Cai Fang, "The Lessons of China's Transition to a Market Economy," *CATO Journal* 16, no. 2 (Fall 1996); Louis Putterman, "The Role of Ownership and Property Rights in China's Economic Transition," in Andrew G. Walder, ed., *China's Transitional Economy* (New York: Oxford University Press, 1996): 85–102; and Louis Putterman, "Dualism and Reform in China," *Economic Development and Cultural Change* 40, no. 3 (April 1992): 467–93.

phenomenon (a short-term drop in output as resources shift, followed by a rise once they have been redeployed).[21] Moreover, because the marketized sector grew more rapidly than the planned sector, the balance between the sectors shifted over time. As a result, the Chinese economy gradually "grew out of the plan" and it was only after the marketized sector had become firmly entrenched that China's reformers began to try to marketize the planned sector.[22] The process was bold in its inception, but not cataclysmic, as it was in Eastern Europe and Russia, with the result that China's reformers were able to proceed "by trial and error, with frequent mid-course corrections and reversals" and muddle through rather than risking the entire process on a single roll of the dice.[23]

The evolutionary school also maintains that as this evolutionary process began to unfold, existing economic actors responded positively to changing incentive structures that linked local government revenues to expenditures, enterprise revenues to profits, and local government revenues to local enterprise profits. By linking local governments' interests to the performance of the local economy, these reforms gave raise to a series of "hybrid" economic institutions suited to the "contradictions" created by the continued coexistence of the plan and the market.[24] Local governments in some areas thus adopted a strategy of "local state corporatism" based on a developmental alliance between local governments and the emerging nonstate sector, "government officials themselves have become market-oriented actors," and "cadre entrepreneurs" forged "corporatist alliances" with the managers of local collectively owned enterprises and private businessmen to overcome weak market structures.[25] In other areas reform gave rise to "state entrepreneurialism" and an "entrepreneurial state" that largely

[21] Justin Yifu Lin, Fang Cai, and Zhou Li, *The China Miracle: Development Strategy and Economic Reform* (Hong Kong: Chinese University Press, 1996). Also see Justin Yifu Lin, Fang Cai, and Zhou Li, "Why Has China's Economic Reform Been Successful?" unpublished manuscript, available at http://www.fraserinstitute .ca/montelerin/papers/china_success/.

[22] Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978–1993* (New York: Cambridge University Press, 1995) and Barry Naughton, "What is Distinctive about China's Transition? State Enterprise Reform and Overall System Transformation," *Journal of Comparative Economics* 18, no. 3 (June 1994): 470–90.

[23] John McMillan and Barry Naughton, "How to Reform a Planned Economy: Lessons From China," *Oxford Review of Economic Policy* 8, no. 1 (Spring 1992): 130–43.

[24] For a critical review of several of the key works in this literature, see Shu-yun Ma, "Understanding China's Reforms: Looking Beyond Neoclassical Explanations," *World Politics* 52, no. 4 (July 2000): 586–603.

[25] Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley, CA: University of California Press, 1999); Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy," *American Journal of Sociology* 101, no. 2 (September 1995): 263–301; and Victor Nee, "Organizational Dynamics of Market Transition: Hybrid Forms, Property Rights, and Mixed Economy in China," *Administrative Science Quarterly* 37, no. 1 (1992): 1–27.

eschewed rent seeking in favor of cooperation with local enterprises or set up its own market-oriented businesses.[26]

As state institutions became market-oriented actors individual cadres also became "bureaucratic entrepreneurs." Yet, because state institutions and cadres remained politically and socially embedded they tended to pursue economic, political, and social goals that provided public goods for their communities and private goods for themselves and their units simultaneously. Thus rather than give rise to a degenerate form of oligarchic rent seeking, partial reform in China spawned a new form of market-based "developmental communism."[27] The combination of a reformist leadership in Beijing and developmentalist governments at the provincial level created a "dual developmental state" in which both center and locality had a common interest in promoting rapid growth.[28] State monopolies thus became "arbitrage-seeking commercial traders" and "quasi-commercial" agencies while the People's Liberation Army became an "entrepreneur" and many of its officers evolved into market-oriented "soldiers of fortune."[29]

The rise of bureaucratic entrepreneurialism was, of course, accompanied by a rise in rent seeking as many nouveaux bureaucratic entrepreneurs sought to parlay their public authority into windfall profits and rents. The ability of individual agencies and localities to engage in extensive rent seeking was, however, limited by the emergence of a "semifederalist" system in which capital became

[26] Jane Duckett, "Bureaucrats in Business, Chinese Style: The Lessons of Market Reform and State Entrepreneurialism in the People's Republic of China," *World Development* 29, no. 1 (January 2001): 23–37; Jane Duckett, "The Emergence of the Entrepreneurial State in Contemporary China," *The Pacific Review* 9, no. 2 (1996): 180–98; Jane Duckett, *The Entrepreneurial State in China: Real Estate and Commerce Departments in Tianjin* (New York: Routledge, 1998); Marc Blecher, "Development State, Entrepreneurial State: The Political Economy of Socialist Reform in Xinju Municipality and Guanghan County," in Gordon White, ed., *The Chinese State in the Era of Economic Reform: The Road to Crisis* (Armonk, NY: M. E. Sharpe, 1991): 265–91; and Marc Blecher and Vivienne Shue, *Tethered Deer: Government and Economy in a Chinese County* (Stanford, CA: Stanford University Press, 1996).

[27] Lance L.P. Gore, *Market Communism: The Institutional Foundation of China's Post-Mao Hyper-Growth* (New York: Oxford University Press, 1998): ch. 3.

[28] Ming Xia, *The Dual Developmental State: Development Strategy and Institutional Arrangements for China's Transition* (Brookfield, VT: Ashgate, 2000): chs. 2 and 8.

[29] Scott Rozelle, Albert Park, Jikun Huang, and Hehui Jin, "Bureaucrat to Entrepreneur: The Changing Role of the State in China's Grain Economy," *Economic Development and Cultural Change* 48, no. 2 (January 2000): 227–52; Albert Park and Scott Rozelle, "Reforming State-Market Relations in Rural China," *Economics of Transition* 6, no. 2 (November 1998): 461–80; Thomas J. Bickford, "The Chinese Military and its Business Operations: The PLA as Entrepreneur," *Asian Survey* 34, no. 5 (May 1994): 460–74; James Mulvenon, *Soldiers of Fortune: The Rise and Fall of the Chinese Military-Business Complex, 1978–1998* (Armonk, NY: M.E. Sharpe, 2000); and James Mulvenon, "Military Corruption in China," *Problems of Post-Communism* 45, no. 2 (March–April 1998): 12–22.

increasingly mobile. If a locality engaged in excessive rent seeking, capital would migrate to other localities while "competitive liberalization" forced local governments to progressively improve market conditions or face an outflow of capital.[30] Local governments thus found themselves forced to rely more on promoting market-oriented growth than predatory rent seeking.[31]

The configuration of forces was such that once the reformers opened a crack in the central planning "monolith," a dynamic process was unleashed that "[pried] the crack open ever more widely" and created "a process of change that became irreversible."[32] This was clearly the case in the agricultural sector, according to Kelliher, Yang, and Zhou, where "spontaneous reform" occurred at the local level as "Mao's serfs" replaced collective agriculture with a new system of household farming, even before the center embraced decollectivization. In fact, spontaneous, bottom-up "reforms" frequently outpaced "top-down" reforms emanating from Beijing and in many cases "reforms" announced by Beijing simply ratified and legitimated spontaneous grassroots reforms.[33] Moreover, limited success early on legitimated progressively more radical reforms and ensured that the reform process did not falter during its infancy.[34] This meant that reform was actually a "phase transition," an:

> evolving, co-evolving, chaotic, self-organizing, path dependent, and mutually catalytic process of change that is driven not by sequencing, as argued

[30] Gabriella Montinola, Yingyi Qian, and Barry Weingast, "Federalism, Chinese Style: The Political Basis for Economic Success," *World Politics* 41, no. 1 (October 1996): 50–81; Wang Yijiang and Chang Chun, "Economic Transition under a Semifederalist Government: The Experience of China," *China Economic Review* 9, no. 1 (Spring 1998); and Dali L. Yang, *Beyond Beijing: Liberalization and the Regions in China* (New York: Routledge, 1997).

[31] Yingyi Qian and Hehui Jin, "Public vs. Private Ownership of Firms: Evidence from Rural China," *Quarterly Journal of Economics* 113, no. 3 (August 1998): 773–808; Yingyi Qian and Jiahua Che, "Insecure Property Rights and Government Ownership of Firms," *Quarterly Journal of Economics* 113, no. 2 (May 1998): 467–96; and Jiahua Che and Yingyi Qian, "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises," *Journal of Law, Economics, and Organization* 14, no. 1 (April 1998): 1–23.

[32] McMillan and Naughton, "How to Reform a Planned Economy": 131.

[33] See Daniel Kelliher, *Peasant Power in China: The Era of Rural Reform 1979–1989* (New Haven, CT: Yale University Press, 1992); Yang, *Beyond Beijing*; Dali L. Yang, *Calamity and Reform in China: State, Rural Society, and Institutional Change since the Great Leap Forward* (Stanford, CA: Stanford University Press, 1996); and Kate Xiao Zhou, *How the Farmers Changed China: Power of the People* (Boulder, CO: Westview, 1996). Also see David Zweig, *Freeing China's Farmers: Rural Restructuring in the Reform Era* (Armonk, NY: M.E. Sharpe, 1997).

[34] Yingyi Qian, "The Institutional Foundation of China's Market Transition," in Boris Pleskovic and Joseph Stiglitz, eds., *Annual World Bank Conference on Development Economics 1999* (Washington, DC: World Bank, 2000): 289–310.

> in the gradualist model, or extensiveness, as argued in the shock therapy model, but rather the structures within which the transition occurs and the dynamic feedback effects generated by the transition process.[35]

And because the transition occurred at the margin between chaos and order, existing institutions could not contain these dynamic forces, yet were still strong enough to prevent the process from degenerating into anarchy. The result was a "balanced" and "continuous" destruction of old structures and construction of new structures, with reforms in one sector driving systemic change without triggering systemic collapse.

While these new hybrids were evolving, resistance from entrenched bureaucratic interests was reduced, according to the second part of the gradualist argument, by adopting a graduated shift from the system of administratively fixed prices and mandatory quotas to a system of floating prices and market allocation.[36] Under the prereform price system, fixed prices had allowed various state institutions to scrap off rents. Price reform thus threatened the interests of strategically placed institutions. By adopting a "two-track" approach to price reform, one that retained fixed prices for "state" consumers but raised prices for other consumers, China's "risk-averse" reformers were thus able to "mitigate the resistance from powerful bureaucrats" by "grandfathering" their rights to preexisting rents.[37] By raising and relaxing controls over out-of-plan prices, however, the two-track system also allowed for partial marketization and hence opened up space for new entrants. As a result, whereas previous reforms in socialist economies had generated antireform coalitions, reforms in China succeeded because there were no losers.[38]

[35] Jin Dengjian and Kingsley E. Haynes, "Economic Transition at the Edge of Order and Chaos: China's Dualist and Leading Sectoral Approach," *Journal of Economic Issues* 31, no. 1 (March 1997): 79–108.

[36] William Byrd, "The Plan and the Market in the Chinese Economy: A Simple Equilibrium Model," *Journal of Comparative Economics* 13 (1989): 177–204; and Zhang Xiaoguang, "Modeling Economic Transition: A Two-Tier Price Computable General Equilibrium Model of the Chinese Economy," *Journal of Policy Modeling* 20, no. 4 (August 1998): 483–511.

[37] Anthony Y.C. Koo and Norman P. Obst, "Dual-Track and Mandatory Quota in China's Price Reform," *Comparative Economic Studies* 37, no. 1 (Spring 1995): 1–17; Lawrence J. Lau, Qian Yingyi, and Gérard Roland, "Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition," *Journal of Political Economy* 108 (February 2000): 120–42; Leong Liew, *The Chinese Economy in Transition* (Brookfield, VT: Edward Elgar, 1997): ch. 7; Leong H. Liew, "Rent-Seeking and the Two-Track Price System in China," *Public Choice* 77, no. 2 (October 1993): 359–75; and Leong H. Liew, "Gradualism in China's Economic Reform and the Role for a Strong State," *Journal of Economic Issues* 29, no. 3 (September 1995): 883–96.

[38] Lau, Qian, and Roland, "Reform without Losers."

Finally, according to Perkins, China's reformers were simply lucky.[39] While hybrid economic forms, compensation of the losers, administrative decentralization, and so forth may have played critical roles in China's transition from the plan to the market, Deng and his allies never had a blueprint for reform. Instead, they crossed the gap between the plan and the market by "feeling for the stepping stones," groping and innovating as they went along.[40] They managed through sheer luck to stumble upon a set of policy changes that the gradualist school points to as the key to China avoiding the pitfalls of partial reform.

Despite their strong disagreement over the efficacy of shock therapy versus gradualism, advocates of both the "evolutionary" and "big bang" schools accept that China's rapid growth was largely a function of favorable structural circumstances. Reform freed the Chinese economy from a series of politically created constraints that had depressed growth during the prereform period. These theorists also agree that reform faced only limited initial opposition because of a combination of prior political developments that had weakened entrenched bureaucratic interests and other potential opponents of reform. The two schools diverge, however, over the question of why the initial winners failed to stall the reform process halfway between the plan and the market, as was the case in Russia. Proponents of the big bang school imply that although the initial winners might have wanted to stall reforms, a strong center was able to prevent extensive rent seeking and could continue to push the reform process forward. Proponents of the evolutionary school, by contrast, tend to see the initial winners as rapidly adapting to the emerging market economy and, because they had to operate outside the plan, developing a vested interest in the deepening of reform. Like big bang theorists, proponents of the evolutionary school also tend to believe that although rent seeking did occur, the fact that power was highly fragmented and constrained meant that local governments and individual state bureaus could engage in rent seeking at the margins but could not force a freezing of the reform process. Both the big bang and evolutionary schools, therefore, conclude that China escaped the worst ravages of incremental and (hence) incomplete reform because, even though rent seeking and corruption increased, the reform process was never halted and China did not fall into the same pit of "predatory," "robber-baron," "vampire," or "mafiya" capitalism that Russia sank into after the collapse of the Soviet Union.[41]

39 Dwight Perkins, "Completing China's Move to the Market," *The Journal of Economic Perspectives* 8, no. 2 (Spring 1994): 23–46.

40 Richard Baum, *Burying Mao: Chinese Politics in the Age of Deng Xiaoping* (Princeton, NJ: Princeton University Press, 1994): 17.

41 See Chrystia Freeland, *Sale of the Century: Russia's Wild Ride from Communism to Capitalism* (New York: Crown Business, 2000): Paul Klebnikov, *Godfather of the Kremlin: Boris*

AN ALTERNATIVE EXPLANATION

Looking back from a vantage point in the late 1990s or early 2000s, one might accept such a conclusion. In the early 1990s, before Deng Xiaoping's "Southern Tour," it was much less clear that China had, in fact, avoided the pitfalls. Between 1988 and 1991, it appeared that reform had stalled and the Chinese economy was beginning to degenerate into chaos as rent seeking "economic warlords" fought repeated "resource wars" and threw up dense networks of "bamboo walls and brick ramparts" around local markets. Corruption seemed to be rising at an explosive rate. Bureaucrats were opening "briefcase companies" (*pibao gongsi*) that arbitraged between the plan and market prices. Managers of state-owned enterprises were engaging in "spontaneous privatization" or "pocket switching," stripping off state assets to create new private firms or "joint ventures" using Hong Kong–based shell companies to disguise the theft of state funds. The sons and daughters of senior cadres, known as the princelings, were going into business, trading their knowledge of the political terrain and access for sizable "consulting fees." An aborted attempt at price reform and excessive investment finally triggered double-digit inflation and panic buying during the summer of 1988.

As corruption, chaos, and anxiety increased, the Chinese Communist Party (CCP) appeared to be increasingly paralyzed. General Secretary Hu Yaobang had been sacked in 1987 largely because of his support of bold reform. His successor, Zhao Ziyang, had been forced to accept the blame for the 1988 inflationary crisis and had been forced to turn over responsibility for economic policy to Premier Li Peng. Li, with the support of conservative patriarch Chen Yun, promptly slammed on the economic brakes with a policy of retrenchment and recentralization that froze the reform process in place. The following spring, after antigovernment demonstrations erupted in Beijing and other major cities, Zhao was ousted as general secretary and replaced by the relatively unknown and putatively weak Jiang Zemin. Following violent suppression of the demonstrations in Beijing, the political atmosphere grew increasingly cold as the party cracked down on antiregime groups and suppressed calls for accelerated reform.

Berezovsky and the Looting of Russia (New York: Harcourt, 2000); Stefan Hedlund, *Russia's "Market" Economy: A Bad Case of Predatory Capitalism* (London: UCL Press, 1999); Stephen Handelman, *Comrade Criminal: Russia's New Mafiya* (New Haven, CT: Yale University Press, 1995); Gustafson, *Capitalism Russian-Style*; Peter Reddaway and Dmitri Glinski, *The Tragedy of Russia's Reforms: Market Bolshevism against Democracy* (Washington, DC: United States Institute of Peace Press, 2001); Grigory Yavlinksy, "Russia's Phony Capitalism," *Foreign Affairs* 77, no. 3 (May–June 1997): 67–80; and Serguey Braguinsky and Grigory Yavlinsky, *Incentives and Institutions: The Transition to a Market Economy in Russia* (Princeton, NJ: Princeton University Press, 2000).

Their ranks decimated by the post-Tiananmen purges and in political disarray, the "liberal" camp was ill positioned to press for a new round of reforms. Li and the "conservatives," however, seemed incapable of rolling back the changes that had been implemented during Hu's and Zhao's tenures.

To some it thus appeared that the transition process had, as White put it, "deadlocked" halfway between the plan and the market in a system plagued by the "worst" features of both systems.[42] Shirk also concluded that, by the late 1980s, reform had "stalled halfway."[43] Stall was, in fact, to be expected, according to proponents of the "fragmented authoritarian" model. Despite an appearance of a centralized, top-down power structure, power was actually diffused across a wide range of centers, each of which held a degree of veto power over decisions affecting its bureaucratic interest. Decisions generally had to be made on the basis of consensus.[44] Those institutions that had enjoyed access to rents before reform and whose rents had been protected during the first two rounds of reform had common cause with other institutions that had gained access to rents and rent-seeking opportunities during the first stages of reform by opposing a further deepening of reform. In particular, both the old entrenched interests and the initial winners had a common interest in blocking price reforms that would have replaced the two-track price system with a system of floating market prices. The two-track system not only bestowed rents on those operating within the plan in the form of depressed input prices, it also created an array of opportunities for various institutions to obtain new rents by arbitraging between price tracks, buying at the fixed price and selling at the market price. The entrenched interests and initial winners also shared a common interest in preserving monopsony and monopoly structures that facilitated rent scraping and limited access to rents. The political system, therefore, seemed to create a situation in which the deck was not only stacked against the deepening of reform, but also was stacked against any effort by Li Peng and the conservatives

[42] Gordon White, *Riding the Tiger: The Politics of Reform in Post-Mao China* (Stanford, CA: Stanford University Press, 1993): 145. Also see Jan S. Prybyla, "Economic Reform of Socialism: The Dengist Course in China," *Annals of the American Academy of Political and Social Science* 507 (January 1990): 113–23.

[43] Susan L. Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993). Shirk, however, also argued that even though rent seeking may have blocked reform of the price system and state enterprises, growth of the nonstate sector was likely to push the transition from plan to market forward.

[44] See Kenneth G. Lieberthal, "Introduction: The 'Fragmented Authoritarianism' Model and Its Limitations," in Kenneth G. Lieberthal and David M. Lampton, eds., *Bureaucracy, Policy, and Decision Making in Post-Mao China* (Berkeley: University of California Press, 1992): 1–30; David M. Lampton, "A Plum for a Peach: Bargaining, Interest, and Bureaucratic Politics in China," *ibid*.: 33–58; and Kenneth Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton, NJ: Princeton University Press, 1988).

to roll back reforms and recentralize economic control.[45] Looking at China in 1990–1, it would have appeared that the big bang argument was correct in claiming that incremental reform was doomed to fail because the beneficiaries of partial reform would still have the political power to throttle the process and keep in place a degenerate system that enabled them to engage in extensive predatory rent seeking.

Although reform seemed to stall out in 1988–9, it did not die. On the contrary, the reform process not only restarted in 1992, it clearly accelerated. By 1993, the Chinese economy seemed well on its way to "growing out of the plan."[46]

The rapid revival of reform in 1992–3 raises two important questions. First, why was China able to escape from the trap of dysfunctional partial reform, given the existence of a political equilibrium that effectively paralyzed the policy-making process? Second, why was there so little opposition in 1992–3 given the depth of opposition to comprehensive reform in 1987–8?

The common answer to the first question is that by 1992 it had become clear that retrenchment was an economic failure and that the failure of retrenchment had become a political liability. Gilley, for example, writes that "Li Peng was eventually swept off the tracks by his own economic policies" and Jiang, with the support of the provinces, attacked and pushed aside Li Peng's attempt to retrench, resocialize, and recentralize the economy.[47] Baum similarly argues that by late 1991, Deng had become "convinced that failure to push ahead boldly with reform would invite the type of disaster that had befallen other communist regimes." He thus left Beijing in early 1992 to rally support in the provinces for an attack on Chen Yun's conservative faction in the capital. As support for Deng's reform initiative mounted outside Beijing, members of the conservative bloc jumped onto the bandwagon one by one, leading to a rapid political realignment that cleared the way for a new round of reform.[48] Huang also points to fear of political unrest as tipping the balance in favor of renewed reform. He argues that Li Peng's retrenchment "overshot" its objective of reining in excessive investment. Instead of cooling off the economy, retrenchment triggered a recession and a surge in unemployment. Moreover, retrenchment failed to cut inflation, leading to a politically dangerous combination of high unemployment

[45] Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk, NY: M. E. Sharpe, 1994): 248; Ruan Ming, *Deng Xiaoping: Chronicle of an Empire* (Boulder, CO: Westview, 1992): 201; and Baum, *Burying Mao*: 327–28.

[46] Naughton, *Growing Out of the Plan*: 273 and 289–390.

[47] Bruce Gilley, *Tiger on the Brink: Jiang Zemin and China's New Elite* (Berkeley: University of California Press, 1998): 173.

[48] Baum, *Burying Mao*: 340–1 and 345–8.

and declining real income. The regime thus began to ease restrictions on credit in 1991 and abandoned its austerity program in March 1992.[49]

Ruan Ming contends that: "Along with the collapse of the coup in the Soviet Union, the policies of 'administrative ratification and readjustment' and 'opposing peaceful evolution' of the Jiang-Li [faction] failed miserably." At this juncture, faced with a solid conservative bloc at the center that threatened his position as supreme political arbiter, Deng turned to the provincial leadership, whose refusal to implement retrenchment had effectively stymied Li Peng's attempt to recentralize the economy, and began building a new countervailing coalition. Aided by Jiang's defection from the conservative camp, Deng broke the conservative coalition's grip on the party center. Once the conservative roadblock had been removed, the reform process took up where it had left off in 1988 even though Deng remained ambivalent about radical reform. "The market economy smashed the 'ideological forbidden zone' that once upon a time had prohibited inquiry into whether an initiative was 'in the nature of capitalism or socialism'" and thus cleared the way for the resurrection of the reform faction within the party leadership.[50]

In contrast to the view that retrenchment failed and that its failure set the stage for the political demise of Chen Yun's conservative coalition, Naughton asserts that retrenchment had stabilized China's economy by the end of 1991. This made possible renewed economic reform without the concurrent threat of inflation and economic instability that had necessitated retreat in 1988. He writes:

> This transition was remarkably smooth, even for the most sensitive commodities. Supplies of most goods were fairly abundant, so there were few extreme surges in price after decontrol. But even more important was the fact that a functioning market had already been created around the remaining plan sectors. . . . The plan had already become the island surrounded by an ocean of market price transactions so the final liquidation of the plan was not difficult.[51]

In this book, I offer a different answer. In line with the evolutionary school, I too see the shift in 1992 as relatively easy – once Deng's Southern Tour and the subsequent crumbling of Chen Yun's antireform coalition had removed the political obstacles to reform. Unlike Naughton, I see the ease of the transition

49 Yasheng Huang, *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era* (New York: Cambridge University Press, 1996): 173–4.
50 Ruan, *Deng Xiaoping*: 242–5.
51 Naughton, *Growing out of the Plan*: 287–9.

to a "socialist market economy" not as a direct function of the success of retrenchment, but rather as a result of uncontrolled and unanticipated changes that had taken place during the retrenchment. Specifically, I contend that a period of chaotic rent seeking, manifest in what is popularly known as "local protectionism" (*difang baohu zhuyi*),[52] crippled the system of state price controls and the monopoly structures that had blocked marketization prior to 1988. As a result, China's economy was considerably closer to de facto marketization in 1992, when political conditions shifted in a direction more favorable to renewed reform than they had been in 1988, when Li Peng sought to block further reform with his policy of retrenchment. I further contend that a process of informal reform transformed the Chinese economy during the retrenchment and that this transformation was possible only because the political stalemate that stalled reform created conditions in which the center could not prevent local actors from unintentionally destroying the foundations of the old command economy. In other words, the Chinese economy evolved out of the plan because political stalemate made it impossible to freeze the transformation halfway between the plan and the market.

Stalled reform may have been a stable political equilibrium – or perhaps more simply a political stalemate – but it was not a stable systemic equilibrium. On the contrary, bureaucratic rent seeking in a context of fragmented authority, wherein the center could not control or prevent unbridled rent seeking, was an inherently unstable systemic equilibrium. The "system" that the opponents of comprehensive reform froze in place when they blocked price and tax reforms in 1988 was inherently unstable because it rested on a series of macroeconomic distortions that only could be maintained by a strong central authority that was capable of preventing opportunistic rent seeking by elements of the state apparatus. Without such an authority and centralized control, competitive rent seeking inexorably leads to the rapid dissipation of rents because competition will quickly push prices upward from the levels fixed by administrative fiat and toward market-clearing levels. Uncontrolled competitive rent seeking will act as a form of de facto price reform.

[52] The Chinese term "local protectionism" (*difang baohu zhuyi*) is a catchall term applied to a wide range of noncompliant local behaviors. Its major use has been in reference to inter local economic conflicts. The term has, however, also been used to refer to local biases in the courts (i.e., a tendency to rule in favor of locals regardless of the merits of a case), the tendency of local cadres to protect each other from outside scrutiny and to cover up each others' misdeeds, and to place the interests of the locality above those of the nation. Many of these practices are also lumped together under the rubric of "localism" (*difang zhuyi*) and refer to the usurpation of power by local governments. As used herein, local protectionism refers to the illicit and irregular use of administrative controls by local governments to interfere with the flow of commodities between localities.

The same structures and veto gates that caused political paralysis in the area of policy making and allowed the proponents of partial reform to block both further progress and retrogression also made it nearly impossible for any bureaucratic institution, including the central leadership, to exercise effective control over the state apparatus. The center was thus unable to prevent individual institutions from engaging in egoistic and opportunistic behavior. In this environment, individual institutions were free to pursue rents recklessly and relentlessly, without regard for the effects of their actions on the sustainability of the structures that created rents and in whose defense they had banded together to block comprehensive price and fiscal reforms. Paralysis on a political level thus created a situation that might be termed "institutional anarchy." Institutional anarchy in an environment of extensive rent seeking, in turn, rapidly and decisively undermined the system of "bureaucratic control"[53] that was putatively frozen in place in 1988.

Specifically, institutional anarchy and bureaucratic rent seeking, manifested in the form of local protectionism, crippled many of the monopoly and monopsony structures left in place during the first two stages of reform. At the same time, it drove prices upward in what amounted to an unplanned process of price decontrols. Local protectionism is something of a catchall term used by both Chinese and Western scholars to denote a range of illegal localist behaviors whose primary objective was the capture and monetization of rents legally "owned" by the center. Local governments, mostly at the subprovincial level, usurped the monopsony and monopoly authority granted them as agents of the center and which were supposed to control the setting of prices and allocation of rent-producing commodities and used their power to "steal" the center's rents. A variety of administrative measures, including bans on exports of undervalued raw materials and imports of overvalued finished products, the construction of local industries through which undervalued raw materials could be transformed into overvalued finished products, were used to block the transfer of rents to other jurisdictions. Similar measures were also used to divert undervalued raw materials onto black markets where they could be sold at prices above the level fixed by state monopsonies.

Ostensibly, local protectionism resulted in the fragmentation of China's internal economy, and worked at direct cross-purposes to central efforts to create unified national markets. By the late 1980s, in fact, local protectionism appeared to have progressed to the point that Chinese and Western observers began to

[53] Janos Kornai, "The Affinity between Ownership Forms and Coordination Mechanisms: The Common Experience of Reform in Socialist Countries," *Journal of Economic Perspectives* 4, no. 3 (Summer 1990): 131–47.

see it as a fundamental threat to the survival of the Chinese state.[54] China, they argued, was rapidly sliding into chaos as "economic warlords" battled for control over rents and split the economy into hostile "economic dukedoms" and fought a series of protracted interregional commodity wars. As the 1989–90 recession deepened, local governments began to build "bamboo walls and brick ramparts" around their jurisdictions. Regional blockades and illegal customs posts as dense as "trees in a forest" blocked the movement of goods and capital between localities. With the center apparently unable to halt the mounting economic chaos, it appeared that China's economy was being dragged ever farther away from marketization. Central paralysis and headlong local rent seeking seemed to be pushing the economy toward economic feudalism as local protectionism undermined even the limited market structures put in place during the first two rounds of reform.

When China's economy failed to collapse into chaos and after the center succeeded in restoring order in fall 1990, most Sinologists relegated local protectionism to the status of another negative consequence of Deng Xiaoping's ad hoc approach to reform. Goodman, for example, wrote that "provincial merchantilism" may have appeared to show that "economic and, by extension, political power has passed, or is passing, from the centre to the provinces." He argued that, when shorn of broad and simplistic historical analogies, crude economic determinism, and the unsustainable assumption that central-provincial relations are inherently antagonistic, the evidence suggested that local protectionism and interregional economic conflicts were manifestations of changes in the "shape" of the current Chinese state, not its collapse.[55]

Fitzgerald warned that the significance of anecdotal evidence of interregional conflicts, including reports of armed patrols to prevent the export of goods

[54] See *Far Eastern Economic Review (FEER)*, October 13, 1988; *Washington Post* (*WP*), December 11, 1988; and *WP*, December 12, 1988; Maria Hsia Chang, "China's Future: Regionalism, Federation, or Disintegration," *Studies in Comparative Communism* 25, no. 3 (September 1992): 211–27; Chien-min Chao, "*T'iao-t'iao* vs. *K'uai-k'uai*: A Perennial Dispute Between the Central and Local Governments in Mainland China," *Issues and Studies* 27, no. 8 (August 1991): 31–46; and Wang Shaoguang, "Central-Local Fiscal Politics in China," in Jia Hao and Lin Zhimin, eds., *Central-Local Relations in China: Reform and State Capacity* (Boulder, CO: Westview, 1994): 106–8.

[55] David S. G. Goodman, "The Politics of Regionalism: Economic Development, Conflict, and Negotiation," in David S.G. Goodman and Gerald Segal, eds., *China Deconstructs: Politics, Trade and Regionalism* (New York: Routledge, 1994): 1–20 and David S.G. Goodman, "Provinces Confronting the State?" in Kuan Hsin-chi and Maurice Brosseau, eds., *China Review 1992* (Hong Kong: Chinese University Press, 1992): 3.2–3.19. On the dubious utility of analogies to the warlord era see also Brantly Womack, "Warlordism and Regionalism in China," in Richard H. Yang, Jason C. Hu, Peter K. H. Yu, and Andrew N.D. Yang, eds., *Chinese Regionalism: The Security Dimension* (Boulder, CO: Westview, 1994): 21–41.

from one region to another, were not only "easily overstated," but that proponents of the fragmentation thesis also ignored signs of increasing interregional cooperation.[56] Chung also pointed out that even if reform had weakened the center and may have unleashed certain centripetal forces, these tendencies toward regional fragmentation were offset by an expansion in voluntary integration in the form of expanded horizontal economic cooperation, a conclusion echoed by Jia and Wang.[57] On the other hand, Yang and Wei saw local protectionism and interregional conflict not as evidence of political fragmentation but rather as a manifestation of the growth of competitive forces unleashed by marketization and the willingness of local governments to take advantage of opportunities to bend policy to their advantage.[58]

Economists came to similar conclusions, viewing local protectionism as a transitory phenomenon born of the economic irrationalities associated with partial reform. Naughton, for example, suggested that even though local governments might erect a variety of trade barriers to protect "their" enterprises, such barriers were apt to have only a limited impact because individual local governments control only a tiny part of the economy. Thus, efforts to impose monopolistic controls were likely to fail in the face of outside competition.[59] Other economists, including those who have devoted the greatest attention to the problem of local protectionism, also minimized its long-term significance, portraying it primarily as a function of price distortions and shortages. It was, they say, a barrier to the growth of integrated markets, but a problem that will ultimately dissipate or be solved through a deepening of price reform.[60]

[56] John Fitzgerald, "Reports of My Death Have Been Greatly Exaggerated: The History of the Death of China," in Goodman and Segal, eds., *China Deconstructs*: 21–58.

[57] Jae Ho Chung, "Central-Provincial Relations," in Lo Chi Kin, Suzanne Pepper, and Tsui Kai-Yuen, eds., *China Review, 1995* (Hong Kong: Chinese University Press, 1995): 3.1–3.45; Jae Ho Chung, "Studies of Central-Provincial Relations in the People's Republic of China: A Mid-Term Appraisal," *China Quarterly*, no. 142 (June 1995): 487–508; and Jia Hao and Wang Mingxia, "Market and State: Changing Central-Local Relations in China," in Jia and Lin, eds., *Changing Central-Local Relations in China*: 35–65.

[58] Dali L. Yang and Houkai Wei, "Rising Sectionalism in China?" *Journal of International Affairs* 49, no. 2 (Winter 1996): 456–76 and Dali L. Yang, "Reforms, Resources, and Regional Cleavages: The Political Economy of Coast-Interior Relations in Mainland China," *Issues and Studies* 27, no. 9 (September 1991): 43–69.

[59] Naughton, *Growing Out of the Plan*: 232.

[60] See Andrew Watson and Christopher Findlay, "The 'Wool War' in China," in Christopher Findlay, ed., *Challenges of Economic Reform and Industrial Growth: China's Wool War* (Sydney, Australia: Allen and Unwin, 1992): 163–80; Keith Forster, "China's Tea War," Chinese Economic Research Unit, University of Adelaide, Working Paper no. 91/3; Zhang Xiaohe, Lu Weiguo, Sun Keliang, Christopher Findlay, and Andrew Watson, "The 'Wool War' and the Cotton Chaos: Fibre Marketing in China," Chinese Economic Research Unit, University of Adelaide, Working Paper no. 91/14; Andrew Watson, Christopher Findlay, and Du Yintang, "Who Won the 'Wool

In this book, I recast the significance of rent seeking and local protectionism. Rather than viewing them as by-products or unintended consequences of partial reform, I consider them critically important forces of change. Rent seeking and local protectionism were, of course, consequences of partial reform and specifically the failure to decontrol prices combined with administrative and fiscal decentralization. The failure to decontrol prices left rents in place. Rents could be monetized by arbitraging between the plan and the emerging market and could also be obtained by moving into the production of scarce consumer goods. Decentralization increased local governments' autonomy and gave them new opportunities to capture rents. Fiscal decentralization linked local spending to local revenues and hence gave local governments motives to seek rents. Partial reform thus triggered a scramble for rents similar to the scramble that erupted in Russia during the early 1990s.

In contrast to those who see China as skipping over the pitfalls of partial reform, I assert that China fell into the pitfalls. As predicted by Hellman, Schliefer, Aslund, and others, partial reform in China unleashed a wave of rent seeking. The dynamics and politics of rent seeking were fundamentally different in China. In Russia, the benefits of incomplete shock therapy were relatively concentrated, giving rise to a new class of powerful oligarchs who were then able to parlay their newfound wealth into the political power needed to bend state policy to their rent-seeking interests. Incremental reform in China, on the other hand, freed local governments to engage in rent seeking. More numerous and less well positioned, the initial winners in China were unable to capture the policy-making process. Instead, they found themselves locked in a fratricidal struggle over rents that ultimately dissipated most of the rents they sought to capture. Moreover, local rent seeking encroached on central rent seeking and effectively robbed the state sector, and the bureaucratic interests that stood behind it, of rents. Local protectionism also deprived in-plan producers of needed inputs and access to markets. Mounting local rent seeking and intensified local protectionism thus split the antireform camp into antagonistic camps.

The lure of rents and the resulting battle for control over rent-producing commodities in China, therefore, triggered a process of change that drove the economy steadily closer to the market. Specifically, rent seeking and local protectionism performed three crucial functions that formal reforms failed to fulfill.

War'? A Case Study of Rural Product Marketing in China," *China Quarterly*, no. 118 (June 1989): 213–41; Anjali Kumar, "China's Reform, Internal Trade and Marketing," *Pacific Affairs* 7, no. 3: 323–39; and Anjali Kumar, "Economic Reform and the Internal Division of Labour in China: Production, Trade and Marketing," in Goodman and Segal, eds., *China Deconstructs*: 99–130.

First, they shattered the monopsony structures through which the state forced down prices for key agricultural commodities and blocked access to these commodities by nonstate consumers. Second, they crippled the state's ability to fix agricultural commodity prices arbitrarily. Third, they moved the economy from chronic shortages to glut. By forcing de facto price reform and undermining the institutional foundations of the planned economy, rent seeking and local protectionism thus produced conditions that made it possible for Deng and the reformers to initiate a third round of reforms in 1992–3. These new reforms were much bolder than those blocked by the conservatives between 1984 and 1988, largely because rent seeking and local protectionism had dissipated the rents that vested bureaucratic interests had sought to defend. Rent seeking and local protectionism, in short, drove China's economy beyond the pitfalls of reform and made possible the rapid growth and marketization that set the experience so dramatically apart from that of other former socialist economies.

OVERVIEW OF THE BOOK

I begin my analysis in Chapter 2 with an examination of the evolution of state policy toward commerce and domestic trade during the early 1980s. China's reformers approached marketization in an ad hoc and often contradictory manner. On the one hand, they recognized the importance of invigorating internal trade and reducing the administrative barriers that had split the Chinese economy into a series of local cells separated from each other by semipermeable barriers. To facilitate market activity, they "commercialized" parts of the economy, scaled back the extent of the planned economy, and allowed greater movement of goods across administrative boundaries. But, the reformers did not simply throw the internal market open. Unwilling to allow complete decontrol and unwilling to cede control over a series of monopsonies that allowed state-owned enterprises access to cheap raw materials and, hence, rents, the reformers attempted to create a semimarketized system wherein monopsonies and monopolies coexisted alongside markets.

This hybrid system was, as I show in Chapter 3, inherently unstable. Herein I argue that by distorting prices, a typical Leninist economy not only creates rents, it also creates a complex series of macroeconomic distortions, including a combination of artificially induced shortages and inflated demand, that can only be sustained through the application of tight, centralized control. Absent tight control, such a system will begin to move back toward equilibrium as diverse actors, including officials and state institutions, seek to capture the rents created by distorted prices. My analysis thus suggests that if reformers decide to concurrently relax controls over economic activity at the same time they decentralize the fiscal system, this will reduce central controls sufficiently to unleash a scramble for rents in which prices will be forced back to market-clearing levels, thus eliminating rents, and supply and demand will be brought back into rough equilibrium.

In Chapter 4, I examine a number of these price wars. Between 1984 and 1991, the Chinese media reported more than sixty "commodity wars," with the most intense periods being 1988 and 1989. During these wars, local governments frequently resorted to what I shall term "export protectionism," by which I mean a reliance on export barriers to prevent the outflow of undervalued commodities. Some involved major commodities, such as cotton, tobacco, silk, wool, ramie, sugarcane, and tea. Most involved relatively minor commodities, including anise, bluish dogbane, melon seeds, castor oil, and licorice root. Many of these minor wars involved commodities not subject to tight state controls after 1984; in many instances, the wars involved little more than a headlong scramble for control over local supplies, followed by a sudden increase in prices. In many cases, prices were ultimately pushed so high that speculative pressures and a surge in supply culminated in the collapse of local markets. Most of these minor wars were also fought over products whose prices the center had already decontrolled. As a result, these wars caused little tangible structural change.

The major wars, on the other hand, involved conflict over institutional structures, specifically between officials who controlled the old state monopsonies and others actors who sought to capture a share of these monopsony rents. When we see the cotton market, the tobacco market, the silk market, and the wool market erupting into a commodity war, we are therefore looking at conflicts that are rooted in the reformers' decision to deregulate and decontrol commodity markets only partially. At the same time, these wars resulted in structural change, not only because they resulted in attacks on the old monopsony system, but also because they drove up prices. By raising prices, they caused supply to expand. Ultimately, rising prices and increasing supply pushed many of these commodity markets to the point at which prices were no longer set by administrative fiat but rather by competitive bidding among rival buyers. Once such conditions existed, effective marketization had taken place and whatever was left of the old monopsony was rendered obsolete. To the extent that monopsony institutions survived the commodity wars, they did so either because local actors had incentives to perpetuate them, albeit as de facto local monopsonies rather than as agents of the central monopsonies, or as institutional artifacts.

As conflicts over agricultural commodities engulfed the rural sector, local protectionism spread into the urban commercial sector. In Chapter 5, I shift from export protectionism to import protectionism. Like export protectionism, import protectionism had its roots in price distortions left in place by the reformers' failure to decontrol prices. Under the old pricing system, the prices of raw materials were generally artificially depressed and those for finished products, particularly consumer goods, were artificially inflated. When industrial reforms undertaken in the mid-1980s reduced barriers to entry, local governments gravitated toward those commodities that commanded high prices and, hence, generated high profits. The result was an expansion in the production of these goods.[61] Excessive investment, however, ultimately led to excess supply. When Li Peng's 1988 retrenchment triggered recession in the winter of 1989–90, local governments moved to seal off local markets and protect local manufacturers from outside competition, seeking to prevent losses of rents and simultaneously avert the possibility of bankruptcies and layoffs. The result was a dramatic increase in the level of import protectionism.

Just as local protectionism appeared to be spiraling out of control, the center stepped in with a couple of proclamations ordering an end to local protectionism. On the surface, the notion that a few of slips of paper could bring a halt to local protectionism must strike some as implausible. But, as I show in Chapter 6, by the time the center stepped in, import protectionism had largely run its course. Whereas export protectionism can be associated with inflationary periods, during which the gap between fixed prices and market-clearing prices will increase, import protectionism is apt to occur during recessions when demand drops below supply, thus forcing producers to compete in tight buyers' markets. Thus, once the economy began to revive in the fall of 1990 and demand began to expand once more, the utility of import protection was already rapidly declining because buyers' markets were already giving way to sellers' markets. Moreover, despite their apparent fixation on monopolizing local markets, rapid expansion of production during the boom years prior to 1989 had made many localities dependent on exports to other markets. The center's demand that local governments dismantle import barriers thus came at an opportune time because it simply reduced the danger of "unrequited cooperation" that otherwise might have deterred local governments from dismantling their import barriers. As I discuss in the latter part of Chapter 6, neither export nor import protectionism disappeared after the end of the 1989–90 recession but after the "high tide" of 1989–90 local protectionism gradually waned as marketization deepened.

In the final chapter, I assess the cumulative effects of rent seeking and local protectionism and describe how they pushed the economy toward the market. Fearful that price decontrols in a condition of shortage would trigger inflation, that inflation would trigger social unrest, and that social unrest would strengthen

[61] See Barry Naughton, "Implications of the State Monopoly over Industry and Its Relaxation," *Modern China* 18, no. 1 (January 1992): 14–41.

the hand of the conservatives, Deng shied away from price reform in 1984. When an overheated economy pushed inflation to double-digit levels in 1988 and rumors of price reform triggered panic buying, Deng backed away from the reform camp and threw his support behind Chen Yun and the conservatives. Three years later, when he faced renewed political pressures to reinvigorate the economy in 1991, Deng had much less to fear from a bold program of reform. Rent seeking had pushed the economy from a condition of shortage to one of glut and had pushed prices progressively upward toward market-clearing levels. The plan and market tracks of the two-track price system had thus converged and many of the rents that had existed in 1984 had disappeared. Many of the monopoly and monopsony structures from which state agencies had extracted rents had also ceased to function effectively. Thus, even before Deng's Southern Tour, conditions had evolved in a manner that was favorable to renewed top-down reform because "dramatic" reform entailed little more than a "rectification of names" that would bring regime policy back into line with economic reality. Thus I conclude that by 1992–3 the chaos associated with China's descent into the pitfalls of incremental reform had, in reality, already produced many of the systemic changes necessary for marketization during the mid-1990s.