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Introduction

This research is an attempt to reconsider the basic theoretical premises of China's political economy. We believe that China's political economy has been seriously misunderstood in the West, and this misunderstanding has created various forms of confusion and conflict among scholars and policy makers in China and the West. Some radical reconceptualizations will help clarify perceptions and misperceptions about China, and thus contribute to our China knowledge and policy making.

In this research, we conceptualize the Chinese political economy system by investigating the interconnectedness between the polity and the economy. While we often refer to China's historical experience, the main focus is on contemporary China. Methodologically, our research questions are positive ones, namely, what the Chinese political economy system is, how it is formed, how it has evolved, and how it functions now.

China's political economy is becoming increasingly important in the field of China studies. In Europe and North America, concepts and theories of political economy have been developed to explain the long process of economic development and growth of the West. Ever since the advent of the modern age, when China began to encounter dominant Western powers, Chinese scholars have gradually accepted "standard" Western political-economic concepts and theories, such as the free market and capitalism, and applied them in interpreting China's economic development and growth.[1] Their explanations, however, remain problematic

[1] Chinese acceptance of Western economics was not a simple process of linear development, of course. Rather, it was mediated and influenced by various political forces and institutional settings. But the overall trend in the late nineteenth and early twentieth centuries was toward full embrace and indigenization of economic research. See Paul B. Trescott, *Jingjixue*: *The History of Introduction of Economic Ideas to Modern China* (Hong Kong: Chinese University Press, 2007).

and misleading. We believe that in seeking to explain China, a scientific concept and theory must be based on China's own experiences, just as scholars in the West have developed concepts and theories based on Western experiences.

Despite China's long history, Chinese scholars had not developed a systemic theory of political economy as their Western counterparts did.[2] Nevertheless, the country had a rich history of practicing different forms of political economy systems in different periods. Conceptualizing Chinese experiences of political economy is an important intellectual enterprise for political and economic theorists and policy analysts. Given the fact that contemporary China has been in transition for more than three decades and is the largest living laboratory for all fields of social science, such an endeavor will shed new light on various important research areas in political economy in general and the Chinese state and economy in particular, and thus improve and deepen our understanding of China. This is particularly true in policy circles, since there is increasing uncertainty about the rise of China.

In this day and age, all theoretical questions related to the rise of China are the subject of heated debate. As the second largest economy in the world, China is exercising increasingly greater influence worldwide. Yet, its political economy system remains a mystery. Is China a market economy? What does capitalism mean in the Chinese context? Is China an example of so-called state capitalism? Perhaps most important of all, what is the relationship between state and market in China, and how has it come into being? Why is this perennially inefficient model, in the eyes of neoliberal economists, so efficient in managing economic crises? Needless to say, such questions have immense implications for theoretical development and policy analysis. Questions such as these have often puzzled China scholars, as they find it difficult to apply dominant theories in economics and political science to China. As a result, many countries are not certain what kind of China policy they should have. Without a sufficient level of knowledge as to what China is, it is not easy to have an effective China policy.

Our motivation to write this book was twofold: first, intellectual curiosity; second, policy considerations. Over the years, we have been puzzled by

[2] As it is used in China today, the term "political economy" (*zhengzhi jingjixue*) refers mostly to an adapted Marxist theory of political economy. But imperial China did have a tradition of policy-oriented political economy studies under the umbrella term *jingji*, literally (Confucian) management of the world.

the long-lasting debate over two related aspects of China's development, namely, market economy and capitalism. We believe that the key to understanding China's recent economic miracle and its likely future lies in a theoretically informed analysis of its ideas and structures in the past and the present. Driven by the urgency of this task, our work here represents an attempt to present a theoretically informed analysis of China's political economy based on its historical experiences and contemporary transformations.

CHINA AND THE MARKET ECONOMY

The first debate between China and the West is about China's market economy status. Since the reform and the beginning of the open door policy, the Chinese economy has undergone an impressive transition to an increasingly market-oriented system. The country has been the beneficiary of global trade and financial investment, and has emerged as an economic power with seemingly unlimited growth potential. Its economic integration into the world system, however, has also generated conflicts between China and the West. Among others, China's market economy status is one of the main issues.

When China joined the World Trade Organization (WTO) in 2001, it agreed to be treated as a nonmarket economy (NME) for up to fifteen years, with the goal of developing into a market economy by the end of the transitional period. By doing so, the Chinese leadership wanted to demonstrate its determination to move the country toward a market economy. A country that is subject to antidumping investigations is classified as either a "market economy" (ME) or a "non-market economy" (NME). While Russia was recognized by the United States as a ME in 2002, China remained in the NME league, together with Albania, Cambodia, Kazakhstan, and Vietnam. The consequence of being classified as a NME is that in antidumping investigations, China's input factory prices cannot be used in the calculation of fair market value of end export products. Price data from a "surrogate" country such as India are typically used instead. The use of surrogate country data often leads to unfavorable rulings for Chinese exporters, and higher dumping duties. In many cases, the choice of surrogate country is a significant source of bias, often serving as a convenient tool to accommodate political pressure from domestic competitors.

From a Chinese perspective, since joining the WTO and reforming its legal system, the country has liberalized its economic system, resulting in unprecedented growth in economic activity and free trade. For China, market economy status is important, as it relates to the antidumping cases in international trade disputes. Understandably, for many years after joining the WTO, when China's leaders met their counterparts from the United States and Europe, they would urge them to recognize China's status as a market economy.

However, from a Western perspective, China is not ready to be granted market economy status, as it is still far from being a market economy in a Western sense.[3] The Chinese state continues to be the ultimate economic decision-making authority. There are still so many areas where the market does not function to regulate the economy, such as poorly defined or protected property rights, an outdated labor system, a continued stranglehold on the financial system, currency fluctuations, and other aspects of macroeconomic policy. All these forms of control and regulation on the part of the Chinese state thwart entrepreneurial activity and reduce economic growth.

Among all these problematic areas, China's state-owned enterprises (SOEs) have generated lasting debate among external observers and become the hallmark of the country's political economy system. Certainly, the sheer size and scope of China's SOE sector has made that country unique among the world's major economies. Due to this gigantic sector, more than anything else, China's system has been coined "state capitalism," an economic system in which commercial economic activity is undertaken by the state, with management and organization of the means of production carried out in a capitalist manner. The system of state capitalism has often drawn scrutiny from abroad and criticism at home. Writing in 2008, Jonathan Woetzel, then McKinsey's Shanghai Office Director, said in a McKinsey report:

> For many years, the West has viewed China's state-owned enterprises in black or white. In one portrayal, they are infiltrators to be viewed with suspicion. An example: Aluminum Corporation of China's (Chinalco) recent multibillion-dollar purchase of a stake in Rio Tinto has raised fears about China's agenda for the acquisition of Australia's resources. The other version sees state-owned companies as muscle-bound goons: without the smarts of a private company but with plenty of brawn. In this characterization, they are relics of a failed economic experiment that still dominate the national economy, controlling natural resources, utilities, and many other vital sectors. Their power and

[3] The most recent iteration of this position came from the Trump administration, which, ironically, had rejected the idea of free trade on many occasions. See "US Seeks to Deny China's Market Economy Status in the WTO," *Financial Times*, November 30, 2017.

influence – particularly their links to the ruling Communist Party and government – have given partners and competitors pause.[4]

While many both inside and outside China have actively urged China to carry out large-scale systematic privatization and to substantially shrink the state sector, China's SOE sector was strengthened rather than weakened by such reforms in the late 1990s. Many in China have perceived the SOE sector as an advantage for the country, not a disadvantage. The SOE sector has been performing many key functions which the private sector cannot bear. For example, SOEs are employed by the state to build large-scale infrastructure, to promote economic growth, to balance a private sector that is perceived as greedy, and, more importantly, to cope with serious economic crises such as the 1997–1998 Asian Financial Crisis and the 2008 Global Financial Crisis. Meanwhile, SOEs can be faulted for their relative economic inefficiency, overexpansion, and self-serving political autonomy while performing these functions.

Due to these problems, there is no consensus in the West as to whether China should be granted market economy status. The issue has been debated in the United States and Europe for years. From a strategic point of view, some have argued that while China is not a "free market" yet, by granting it market economy status, the West would be able to offer a welcoming step in the right direction for a freer, more prosperous China. The country needs to be pushed to liberalize its economy and increase global competition.

Both within and outside China, for those who believe that China should be granted market economy status, there are reasonable arguments. A few arguments include: First, barring a few strategic economic sectors with significant government ownership (such as in banking, telecommunications, transport, and energy, none of which are abnormal in many other market economies), most other sectors in China are competitive, with hundreds of companies as players and razor-thin profit margins. Second, China's privatization is incremental. A sweeping privatization policy cannot occur overnight. The West should recognize China's developments in market liberalization. Third, failure to acknowledge China's market economy status could hamper trade relations between the West and China. The West is much wealthier because of China, and China's export industry flourishes because of free trade. In other words, free trade makes society

[4] Jonathan R. Woetzel, "Reassessing China's State-Owned Enterprises," *The McKinsey Quarterly*, July 2008, p. 1.

better off while protectionism makes it worse off. Fourth, the refusal to grant China market economy status is largely political. It is nonsensical and, in a sense, discriminatory. Treating China as a nonmarket economy is at odds with willingly recognizing Russia as having market economy status.

It is not so difficult to discover a similar logic behind the arguments of those both for and against granting China market economy status – namely, that China will become "more like us," in James Fallows' term.[5] Those who are pro-China believe that a more liberal China policy will make that country more liberal; those who are against it believe that a harder China policy will force the country to be more liberal. Indeed, China has been regarded as a postsocialist transitional economy, or a semimarket economy in transition.

Nearly two decades after China joined the WTO, the country is now the largest trading nation in the world. The country has moved from capital shortage to capital surplus, and its capital has gone up globally. While market economy status is no longer important for China, the West, particularly the United States, continues to raise questions about the nature of state capital. For instance, under the Obama administration, the United States tried to convince eleven Pacific nations to join a "next generation" trade agreement called the Trans-Pacific Partnership (TPP). Had it succeeded, it would have been the most important trade initiative since the 2001 launch of the WTO's Doha round collapsed, since it would bind two of the largest economies – namely, the United States and Japan – into a bloc covering 40 percent of global output. The TPP excluded China, but included Vietnam. This was a deliberate move. The TPP was the United States' "trade pivot" to Asia, and it was expected that Beijing might be pushed into reforming its economy so it could join at a later stage.[6] Again, the purpose was to promote economic liberalization in China. One can predict that as long as China's economic system does not run along the same lines as those in the West, such battles will continue in the future.

Therefore, for the scholarly community, the question of whether China will become a free market economy remains important. Among scholars and policy makers in both China and the West, the common position is to view China's economic transition as a process from planned economy to

[5] James Fallows, *More Like Us: Making America Great Again* (New York, NY: Houghton Mifflin, 1989).
[6] David Pilling, "Round Two in America's Battle for Asian Influence," *The Financial Times*, April 1, 2015.

market economy. The question is how complete this transition is. There is no doubt that since reform, China's economy is becoming increasingly market-oriented and less planned. But two conceptual questions can be raised. First, do scholars and policy makers in and outside China understand the market economy in the same way? Second, is the market in China becoming similar to those we can observe in the West? If we add these two questions to the "great divergence" debate, we can raise the question: Will China and the West converge in terms of development of the market economy?

Empirically speaking, the answer to this question is rather certain: China is not going to become a market economy such as we have seen in the West. For example, while China is moving toward a market economy, the state has consistently emphasized that the SOE sector should occupy a central position in the country's economic structure. This was confirmed once again in the most important document on economic reform in the post-Deng Xiaoping era, passed at the Third Plenum of the Eighteenth Chinese Communist Party in November 2013. The leadership overwhelmingly emphasized marketization as the direction of China's economic reform, but it also reiterated that state ownership is a "pillar" and "foundation" of China's distinctive economic system and its "socialist market economy." Therefore, one must go back to the basic question: What is China's political economy system? Without an answer to this question, we will continue to misperceive China.

CHINA AND CAPITALISM

The second, and related, debate between China and the West is about the relationship between the market economy and capitalism. Here our intellectual curiosities lay in both economic growth and capitalist development.

The thrust of the debate was also nicely captured in the concept of the Great Divergence, which, as historian Kenneth Pomeranz frames it, centers on the following question: "Why did sustained industrial growth begin in Northwest Europe, despite surprising similarities between advanced areas of Europe and East Asia in the eighteenth and nineteenth century?"[7] Phrased another way: "Why was China not able to develop a system of

[7] Kenneth Pomeranz, *The Great Divergence: China, Europe, and the Making of the Modern World Economy* (Princeton, NJ: Princeton University Press, 2000), p. 1.

modern capitalism even though there was the period of the 'sprouts of capitalism'"?[8] Over the years, scholars both within and outside China have struggled to identify perceived important factors which led to different paths of economic development in China and the West, but have met with limited success.

There have been two different answers to this question: "long-term lock-in theories" and "short-term accident theories," following the terms of historian Ian Morris.[9] The "long-term lock-in theories" came first. From Montesquieu onward, and during the nineteenth century, the predominant scholarly view of China in the West was of an "oriental despotism" without the self-propelling political and economic dynamism. This view of China as a country "without a history" reached its apogee in Karl Marx's writings. In Marx's view, Asiatic despotism was characterized by an absence of private property in land; large-scale, state-run irrigation systems in agriculture; autarchic village communities combining craft with tillage and communal ownership of the soil; bureaucratic cities; and a despotic state machine which appropriated the bulk of the economic surplus. Unlike European political economy, which Marx viewed as progressing from slavery to serfdom, feudalism, capitalism, and ultimately communism, the Asiatic mode merely had cycles of dynastic rise and fall, not an evolutionary history. This led Marx to view the violent intrusion of Western colonialism in a positive light, liberating Asian peoples from "Oriental despotism."

Based on the Marxist concept of the Asiatic mode of production, Karl Wittfogel, in his monumental work *Oriental Despotism: A Comparative Study of Total Power*, came up with an analysis of the nature of China's political economy system.[10] According to Wittfogel, over the course of the imperial period, China had developed not only private property but also considerable commercialization, monetization, and handicraft industries; however, due to the specific feature of Chinese ecology, the state had a special function to play in organizing large-scale hydraulic works, which necessitated the development of a full-time professional bureaucracy and allowed a despotic monarchy to retain its political dominance despite the rise of commerce. This complex hydraulic system

[8] For example, David Faure, *China and Capitalism: A History of Business Enterprise in Modern China* (Hong Kong: Hong Kong University Press, 2006), pp. 11–12.
[9] Ian Morris, *Why the West Rules – For Now: The Patterns of History and What They Reveal About the Future* (London: Profile Books, 2011), pp. 11–13.
[10] Karl August Wittfogel, *Oriental Despotism: A Comparative Study of Total Power* (New Haven, CT: Yale University Press, 1957).

of political economy was highly stable, with merely cyclical change as the fortunes of dynasties waxed and waned.

Such a critical view of China's political economy was also present and dominant among Western Sinologists of older generations. For example, historian John Fairbank and his coauthors distinguished two basic models of industrialization: the British model and the Chinese model. In the British model, modernization was endogenous. According to Fairbank and his colleagues,

> the traditional pre-industrial order itself provided a framework for gestation. The commercial revolution of the mercantile period and the agricultural revolution following it were the necessary precursors of the industrial revolution in England. Endogenous, i.e., internally generated, forces played a dominant role in the rise of disequilibriating forces in the form of new inventions, advances in technology and innovations.[11]

By contrast, China was seen to fit into the second basic model of industrialization, in which traditional equilibrium needed to be disturbed exogenously before modernization could take place:

> China of the early nineteenth century had a circular flow economy in which production was absorbed in consumption, with very little if any net saving, so that the economy merely reproduced itself without advancing. While there was some commercialization of the economy, it was not a major disequilibriating change.[12]

Joseph Needham, who produced the multivolume magnum opus *Science and Civilization in China*, also tended to take this view.[13] Needham recognized that China occupied a fairly dominant position in global technical progress up to around 1500. For Needham, the puzzle was: Given that the effects of all Chinese inventions and engineering solutions on the technology of post-Renaissance Europe were self-evident, why did they not lead to a similar upsurge of industrialism in China? Needham suggested that social analysis provides the answer to this question, arguing that Chinese "bureaucratic feudalism" was able to digest a wide array of discoveries and inventions which acted like time bombs in the social structure in the West.

[11] J. K. Fairbank, A. Eckstein, and L. S. Yang, "Economic Change in Early Modern China: An Analytic Framework," *Economic Development and Cultural Change* 9 (1960), p. 2.
[12] *Ibid*., pp. 4–5.
[13] Joseph Needham, *Science and Civilization in China* (Cambridge: Cambridge University Press, 1954–2008). To date, twenty-seven volumes have been published.

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The "short-term accident theories" came into existence in response to the "long-term lock-in theories" and were put forward by the California School of global history, including historians such as Bin Wong and Kenneth Pomeranz. According to these scholars, whatever we look at – ecology or family structures, technology and industry or finance and institutions, standards of living or consumer tastes – the similarities between China and the West, and in particular between China's Yangtze River Delta and Britain, vastly outweighed their differences as late as the nineteenth century. In that case, why did industrialization and capitalist development occur in the West and not in China? Pomeranz essentially argued that Western Europe, and above all Britain, just got lucky. The West's first stroke of luck was the accidental discovery of the Americas, creating a market for cheap produce and a West-dominated trading system that provided incentives to industrialize production. A second and important lucky break was that Britain alone in the world had conveniently located coalfields, as well as rapidly mechanizing industries.[14]

Inside China, particularly since the establishment of the People's Republic in 1949, economic development and capitalism in the premodern era has been a major research topic, if not a political one, and a huge amount of scholarly research has been devoted to the economic history of the Ming and Qing dynasties in search for the "sprouts of capitalism."[15] Outside the Marxist school, liberally minded Chinese scholars have produced general works on the imperial Chinese state and economy, which mirrored the bias of oriental despotism. For example, Wang Yi refines the oriental despotism thesis in his magisterial survey of the fiscal system of the late Ming dynasty by arguing that the system was characterized by irregular taxes and surcharges, predatory officials and fiscal agents, and ruthless exploitation

[14] Kenneth Pomeranz, *The Great Divergence* (Princeton, NJ: Princeton University Press, 2000). See the Introduction for the historical context and conceptualization of the Great Divergence, and the Conclusion for the role of historical contingencies.

[15] The most representative of this body of scholarship is the voluminous *Zhongguo zibenzhuyi fazhanshi* (in three volumes) produced by the Chinese Academy of Social Sciences under the editorship of Xu Dixin and Wu Chengming. The first volume deals with the question of underdevelopment of Chinese capitalism in Ming Qing China following a Marxist framework. For the English version of the first volume, see Xu Dixin and Wu Chengming, eds., *Chinese Capitalism, 1522–1840*, English translation by Li Zhengde, Liang Miaoru, and Li Siping, edited and annotated by C. A. Curwen (London: Macmillan Press Ltd, 2000).