Introduction: Economic Market and Political Market

> The market and bureaucracy are not a gin and tonic that can be mixed in any proportion wanted. There may be a certain level of bureaucratic market restrictions which still allows breath for the market. But beyond a critical limit, bureaucratic restriction cools down the live forces of the market, kills them – and only the appearance of a market remains. And there exists a combination of market and bureaucracy which unites, as it were, only the disadvantages of the two, while the separately existing advantages of both are lost.

Janos Kornai, the dean of socialist economics, wrote these remarks before the collapse of communism in Eastern Europe (1990: 14). His focal concern was the intermittent, largely unsuccessful attempts to incorporate market mechanisms into centrally planned economies in the Soviet Bloc during the preceding two decades. Indeed, the setbacks to such attempts were so severe and widespread that there was a growing consensus that in a partially reformed command economy market forces were unlikely to outgrow and redefine the institutional parameters set by the communist state,[1] much less become the primary driver of sustained economic growth.

China's reform experience since 1978, however, tells a different story. The central planning system, along with strict state ownership, has steadily declined. Markets have grown to become the center of economic activities. The net output of the economy has on average increased by 9.7% per year (GJTJJa 1999: 58), and the standard of living has greatly improved, as reflected in the World Bank's recent re-classification of the country from the "low income" to the "lower middle income" category (World Bank 1998: 187–91). These changes have taken place without an overhaul of the political system. This poses a challenging

[1] See, for example, the articles on Eastern Europe in Nee and Stark (1989).

question: What has driven and sustained marketization in the shadow of bureaucratic interests, habits, and restrictions while keeping the economy from being trapped in the worst of the two worlds described by Kornai?

A further intriguing twist in China's recent economic transformation is that it has been accompanied by a significant growth of political corruption and, relatedly, rent-seeking activities.[2] In 1995, for example, Chen Xitong, Mayor of Beijing and a member of the Politburo of the Chinese Communist Party (CCP hereafter), was arrested (along with a number of his deputies) on corruption charges (*RMRB*, July 3, 1995). In 1998, Luo Ji, Director of the Anti-Corruption Bureau,[3] was removed from office for making illicit use of illegal funds uncovered in the Bureau's investigations (*RMRB*, March 11, 1999). In 1999, Cheng Kejie, a vice chairman of the Standing Committee of the National People's Congress, was arrested (and later executed) for taking bribes in return for granting, among other things, government contracts, quotas, and loans (*China Daily*, August 23, 2000, September 15, 2000). The diversion of public authority and assets as represented by these high-profile cases has become so widespread and deep-seated throughout the state apparatus that CCP leaders have openly recognized the seriousness of the problem, calling the fight against it a matter of "life and death" for the communist state (*RMRB*, February 27, 1998).

Political economists have long argued that pervasive corruption and rent seeking are detrimental to economic growth (e.g., Krueger 1974; Myrdal 1968; Olson 1982; Tullock 1967). They have substantial evidence to point to, ranging from economic retardation in many developing countries to stagnation and decline in some industrialized economies. How, then, should the contrast between their argument and what has happened in China during the past two decades be explained?

This book seeks to address these puzzles by analyzing the mechanisms – causal processes (Elster 1989) – of economic institutional change. I focus on the industrial sector – the largest contributor to China's eco-

[2] Political corruption refers to illicit use by government officials of public authority and assets for private purposes (Nye 1967; Rose-Ackerman 1978: 7). Rent seeking has to do with the socially costly pursuit of redistributive gains (e.g., monopoly profit) (Tollison 1982). Rent seeking may or may not involve political corruption, as it may take place within the confines of existing regulations or in the "gray area" between legal and illegal behavior. In this study, however, I will use the more encompassing term "favor seeking" to describe the exchange relations between state agents and economic actors. See the discussion below.

[3] The Anti-Corruption Bureau operates under the People's Supreme Procuratorate. Along with the Ministry of Supervision and the Central Discipline Inspection Commission of the CCP, it is one of the major internal watchdog agencies of the Chinese state.

nomic output,[4] and examine the forces that have shaped the paces, strategies, and outcomes of the transition of industrial firms from the plan to the economic space outside it.[5] The lead question of my investigation is how the competitive advantage of firms has been formed in two emergent markets, the economic and the political. The economic market involves the exchange of goods, services, and factors (capital, labor, and land) among economic actors. In the political market,[6] state-controlled resources, opportunities, and exemptions from societally shared liabilities are exchanged by state agents with each other and with outsiders for self-defined purposes – especially for private gain – that often deviate from publicly announced agenda of the state.[7] Neither market was highly developed in the Mao era (1949–76). Both are pervasive today. An account of their growing role in shaping the behavior and performance of firms thus sets the stage for a close examination of why and how these markets have evolved from a system of central planning and ideological control, how the rules of the economic game have been redefined along the way, and why the economy has steadily grown despite the state's increasing inability to maintain its own organizational health.

Competing to Win

A central feature of post-Mao China is that the economic landscape has become increasingly crowded and competitive. From 1978 to 1998, the number of industrial enterprises rose from 1.2 million to nearly 8 million (GJTJJa 1987: 233, 1999: 421; ZGXZQYNJBJWYH 1988: 573). Most of the newly formed enterprises are domestically funded, but foreign investors have also entered the scene and steadily increased their presence since the adoption of the "open door policy" in 1979. By the end of 1997, the total number of foreign capital enterprises was in the order

[4] In 1998 the industrial sector contributed 42.2% of China's gross domestic product (GDP) (GJTJJa 1999: 13).
[5] In this study, the term "firms" is used interchangeably with "enterprises" and "economic organizations" to refer to for-profit organizations that transform inputs into output.
[6] The notion of a political market is sometimes used in studies of vote manipulation and swapping in the West (e.g., Pelzman 1990; Ramseyer and Rosenbluth 1993; see also Mueller 1989 and North 1990). As I will show below, the political market that has emerged in post-Mao China is not driven and constrained by competitive party politics. Rather, it involves a wide range of state action beyond voting and thrives on favor exchange through diffused social networks.
[7] By state agents I mean functionaries of the government and the CCP who have varying levels of authority in the three areas mentioned here. They are also referred to as "officials" in this book. Managers of public enterprises, along with private entrepreneurs, are regarded as "economic actors" in that they do not have allocative and regulatory authority beyond their own organizational boundaries.

of 300,000, including those set up by over three hundred *Fortune* 500 corporations (BJWYH 1998: 9). Starting from the manufacture and retail of low-end consumer goods, the newcomers have gradually made their way into almost all the other economic sectors, competing directly with existing enterprises and with each other in input supplies and output sales. After more than two decades of disappearance, marketing made a comeback in the spring of 1979, when the Shanghai TV station aired a commercial for the Swiss watchmaker Rado (*BJWB*, March 14, 1999). Since then advertisements have multiplied and flooded the mass media and other channels of communication. New domestic brands such as Changhong (electronic products), Haier (household electrical appliances), and Wa Ha Ha (food and beverages), along with Coca Cola, Kodak, 555, and their likes, have become widely recognized names.

This sea change has captured the attention of analysts. A group of economists has developed a theory, referred to below as the "economic competition thesis," to explain the central role of competition in driving China's recent economic growth and institutional change.[8] They argue that growing competition in product and factor markets developed from the periphery of central planning has drawn increasing numbers of enterprises from the plan to market-oriented economic activities by rewarding those that can make efficient use of resources and penalizing those that fail to do so.

Together with interfirm competition in product and factor markets, however, there has grown another type of competition – that between local governments. Many of the enterprises formed in the reform are "owned" by local governments and operate outside the central plan. Their growth and competitiveness have drawn greatly on the resource support, regulatory flexibility, and managerial incentives provided by their owners. Before the plan's demise in the mid-1990s,[9] many local governments even used their administrative power to back local enterprises against nonlocal ones in what has been described in Chinese media as "raw material wars" – fierce competition for locally produced industrial inputs that were in short supply, such as cotton, silkworm cocoon, tobacco leaves, and wool (e.g., *RMRB*, July 21, 1986, December 17, 1986, April 22, 1988, August 12, 1989). Following the example of cen-

[8] For elaborate accounts of this view, see Jefferson and Rawski (1994a, 1994b), Naughton (1992b, 1994a, 1994b, 1995a), McMillan and Naughton (1992), and Rawski (1994a, 1994b, 1995, 1999).

[9] In October 1992 the 14th CCP Congress formally abandoned the traditional emphasis on central planning and redefined China's transforming economy as moving in the direction of a "socialist market economy." In 1993 and 1994, the CCP spelled out detailed plans to bring this vision to reality, which were accompanied and followed by a constitutional amendment and a host of new laws and regulations aimed at clearing up the remains of central planning. See *RMRB* (December 12–14, 1998) for a chronology of the sequence of relevant events.

trally designated special economic zones in southern coastal areas, lower level governments have also established within their own jurisdictions various special policy enclaves, totaling 4,210 in 1997 (*RMRB*, January 23, 1998), to compete for investment, technology, and other resources from domestic and international sources.

In view of these developments, some scholars have proposed another explanation, which I call the "local developmental state thesis," to account for the driving forces behind the transition of enterprises from the plan to markets.[10] It is mainly concerned with the responses of local governments to the incentives created by fiscal decentralization during the reform, which has significantly strengthened the tie between local officials' financial and career rewards and the growth of local government revenue. According to this theory, efforts to expand the revenue base have led local officials to mobilize resources and bend existing rules for local enterprises' market-oriented activities that compete with those promoted by governments in other localities. The result is a weakening of commitment to the plan and a broadening of avenues to markets.

These contrasting views highlight two different drivers of economic change: market and hierarchy, which Charles Lindblom (1977) defines as being based on exchange relations and authority relations respectively. The economic competition thesis emphasizes the push-and-pull effects of cumulative competitive forces generated by the self-arranged exchanges of firms in product and factor markets. The local developmental state thesis recognizes the increasing market orientation of firms' activities and extends the notion of competition to interlocality interactions. Nevertheless, it focuses on the relationship between firms and local governments and treats it as a principal-agent issue involving control, monitoring, and incentives under restructured authority relations, rather than as a market phenomenon.

I see both views as capturing important aspects of reality and, despite the tension between them, complementing each other. Drawing on the insights from these views, this study seeks to cast light on what lies between them – i.e., the relationship between market and hierarchy, which I think holds a key to understanding the economic change in post-Mao China. I argue that market may be embedded in hierarchy and erode its foundation from within, instead of being spatially separated from it. In the reform era exchange relations have grown not only among economic actors, but also under hierarchical settings of interaction – between economic actors and state agents and among state agents themselves. It is the concurrent growth and mutual reinforcement of exchange

[10] There are differences, though, in the focus of analysis among various studies sharing this view. For details, see Byrd and Lin (1990), Lin (1995), Oi (1992, 1995, 1999), Montinola, Qian, and Weingast (1995), Qian and Xu (1993), and Walder (1995a, 1998).

relations in the economic and political processes that have driven much of the observed changes in China since 1978.

The working hypothesis that I use to develop a further explanation is the following: In the reform era, effective manipulation of state action – i.e., making gains from ad hoc favorable treatment by the state – constitutes a necessary condition for the success of firms. By scrutinizing evidence that confirms, qualifies, or contradicts this hypothesis, I search for clues to understanding a central feature of the post-Mao Chinese political economy. That is, the communist state has been transformed from the central leadership's tool of social engineering, guided by ideology and organized through close-knit authority relations (Schurmann 1968), to a marketlike place where the center loses coherent control and public authority and assets are extensively traded by state agents at various levels for self-defined purposes.

To see how this change has been related to the behavior and performance of industrial firms and what such a relationship reveals about the mechanisms of economic institutional change, it is important to take a look at the influence of state action on the distribution of advantages and disadvantages among firms before and since the reform.

Particularism under the Plan

The constraints and opportunities that firms face in their environments have a direct bearing on the selection and outcome of their strategies. In modern society the road to a firm's success may be seen as originating from two major sources: interaction among economic actors, and actions of the state. Identifying promising opportunities for value creation, making productive use of resources through coordinated efforts of employees, and realizing intended gains through smooth transactions with suppliers and buyers are among the important factors that contribute to the ability of a firm to excel. On the other hand, because the state usually allocates considerable amounts of financial, physical, and human resources, regulates economic opportunities, and distributes societally shared obligations (such as the costs for providing public goods and fixing negative externalities), differential treatment by the state in these aspects may significantly tilt the balance of gains among firms. Therefore, unless the state is impartial to all firms, variations in the direction and impact of state action are of great relevance to how firms behave and fare.

For over two decades after the "socialist transformation" in the mid-1950s, the influence of state action on the choices and rewards among Chinese enterprises was so overwhelming that the role of independent decisions and actions by economic actors was reduced to a minimum.

Under the central planning system, the state monopolized the allocation of all the economic resources and opportunities and tightly controlled the decision making regarding their use. Enterprises with high priority in the pecking order of centralized resource allocation were systematically better accommodated in the supply of factors and material inputs, given generally more favorable terms of trade, and granted more generous packages of financial and material rewards for their employees, than enterprises with low status.[11] The former included large, centrally controlled capital goods producers in the state sector; the latter were represented by small, locally controlled consumer goods producers in the so-called "collective" sector (Eckstein 1977; Solinger 1991a; Walder 1986).

Although vertical bargaining existed between enterprises and their supervising authorities, it was mainly pursued as a way for enterprises to finesse for breathing space by maintaining a certain level of organizational slack rather than to maximize financial returns (Rawski 1975). Whether an enterprise could be upgraded to a higher status in the hierarchy of resource allocation was mainly a matter of the interaction between different administrative levels of the state rather than between the enterprise and its supervising authorities (Granick 1990; Lieberthal and Oksenberg 1988). Moreover, although the central planning system was not without loopholes, the discretion of individual officials to change the terms of treatment for different enterprises was severely restrained by long and complex decision chains, difficulties of finding grounds of justification, and divisive organizational politics (Harding 1981; Shirk 1982; Walder 1986). Consequently, a clear and stable pattern of winners and losers was centrally defined and sustained. What this pattern signified was a highly institutionalized particularism in resource allocation and regulation, and an underdevelopment of exchange relations in both the economic and the political process.

The reform era has seen drastic changes. The once overwhelming shadow of central planning has faded away, and economic decision making has been significantly decentralized, especially at the level of the firm (Naughton 1994a, 1995a; World Bank 1992). Many previously disadvantaged enterprises, such as those formerly known as commune and brigade enterprises in rural areas and now called township and village enterprises (TVEs hereafter), have become prominent winners (Byrd and Lin 1990; Ma Rong, Huang Chaohan, Wang Hansheng, and

[11] Under the prereform system, much of the surplus (accounting profit) of enterprises was extracted and redistributed by the state. As a result, the ratio between input and output did not bear a clear correlation with the actual gains accruing to different enterprises. The advantages of the most favored enterprises consisted mainly in the quantity, quality, and stability of the resources allocated to them and in the allowance for the provision of extra benefits to their employees. See Chapter 2 for more discussion of this.

Yang Mu 1994; Oi 1999; Walder 1998).[12] They are joined by increasing numbers of other new forms of economic organization, such as foreign capital enterprises, private enterprises, and joint ownership enterprises, which have risen from nonexistence to a solid segment of the economy, accounting for 40% of the gross industrial output and 63% of the total retail sales of consumer goods in 1998 (GJTJJa 1999: 421, 546–7). In contrast, many previously privileged enterprises, especially those in the state sector, have lagged behind in performance; some have even fallen to the ranks of losers (Steinfeld 1998; Woo 1999; Zheng Haihang 1998). As a result, one can no longer construct a clear profile of winners and losers by using a few structural indicators, such as ownership classification, administrative rank of an enterprise's immediate supervising authority, sector, and size.

Many changes have accompanied and contributed to such reshuffling of winners and losers.[13] The most obvious development is the rise of markets for products and (to a lesser degree) factors, as well as a concurrent intensification of competition in these markets. This raises two questions. Does the expansion of concrete markets represent a corresponding growth of a particular modus operandi of economic activities, known as "the market," where winners and losers are determined by the anonymous interplay between demand and supply? How has the role of the state in the selection of winners and losers changed?

Competitive Advantage in Economic Transition

To address these questions, let me begin with the notion "market." The simplest way to define market is to see it as a nexus of trade. In *Webster's Ninth New Collegiate Dictionary*, for example, the first definition of market is "a meeting together of people for the purpose of trade by private purchase and sale and usually not by auction." But such a definition often fails to capture the whole meaning of the term in use – not only in academic literature but in journalism. When market is referred to as a mode of resource allocation and economic coordination – often

[12] I define winners and losers in the reform era as enterprises with above or below average financial performances (see Chapter 1 for a discussion of performance indicators). I focus on the relative standing of individual cases rather than the absolute level of their performance. Seen in this light, losers need not be in the red or face immediate threat to survival, which may be sustained by a variety of economic and noneconomic factors (Meyer and Zucker 1989). Nor do those with above average performance necessarily achieve it through efficient use of resources in economic activities.

[13] For overviews and comprehensive discussions of the Chinese reform, see Bell, Khor, and Kochhar (1993), Davis and Vogel (1990), Harding (1987), Naughton (1995a), Perkins (1988, 1994), Perry and Wong (1985), and Walder (1995b).

known as "the market" – its rudimentary function of providing a nexus of trade is seen as being integrated with two other functions: a locus of information and incentives, and a screen through which the relative payoffs to the participants in exchange are determined. The levels and ups and downs of prices may carry important information (and misinformation) to economic actors, thereby forming a frame of reference and posing positive and negative incentives to their decision making. Also, given equal protection of property rights and freedom of enterprise and trade, the payoffs to each economic organization may be subjected to the independent decisions of other participants in economic activities (especially output buyers, input and factor suppliers, and competitors) on price, quantity, and transaction. Consequently, the economic prize goes to the most efficient players while the inefficient players are penalized and weeded out. When all these three functions are brought into full play, what emerges is the ideal-typical picture of a market economy (Samuelson and Nordhaus 1985; Stiglitz 1993).

How far and in what ways the reality in advanced capitalist economies differs from this ideal type has been a matter of debate.[14] The relevant issue here is how this conception contrasts with economic change in a transitional economy like China's where concrete markets have been expanding and affecting the decision making and performance of economic organizations.

Economic Competition

The economic competition thesis argues that the growth of markets for products and factors in the reforming Chinese economy represents a mutual inducement and consequently more or less concurrent expansion of the above three roles that markets may play.[15] Such a process has taken place through piecemeal economic reform that opens up limited spaces for self-arranged trade among economic actors, especially those operating on the periphery of central planning. The competitive forces spawned

[14] The conventional view, based on neoclassical economic theory, of Western capitalist economies as resembling this ideal type has been challenged by many studies. See, e.g., Galbraith (1967), Granovetter (1985), Lazonick (1991), and Lindblom (1977).

[15] A contending view is the so-called big bang theory, championed by Jeffrey Sachs, of economic change in former communist economies. Despite explicit statements made by some of those sharing the economic competition thesis to criticize the works of Jeffrey Sachs and his associates (e.g., Rawski 1994a, 1995), the main difference between them is not concerned with what a well functioning market system is like – both seem to see it in the light of the ideal-typical image described above. Rather, it lies in the institutional and organizational prerequisites for such a system to emerge and take shape. See Sachs and Woo (1994a, 1994b) and Woo (1994, 1999) for summaries of the focal issues under debate and critiques of the economic competition thesis, and Rawski (1995) for a spirited rebuttal (see also Rawski 1999).

in such openings have in turn amplified the role of markets in signaling information and incentives and screening winners and losers, thereby intensifying the drives and pressures for further reform. Although the economy has yet to be fully marketized, it is increasingly "marketlike." In the words of Rawski (1994a):

> In essence, institutional changes arising from partial reform created a virtuous circle in which the growing intensity of competition not only rewarded winners and punished losers, but by crippling the growth of fiscal revenues, diminished the ability of the state to protect losers from the consequences of high costs, poor quality, and other long-standing habits carried over from the planned economy . . . Partial reform has produced 15 years of strong growth and stimulated massive shifts from plan to market, from rent-seeking to profit-seeking, and from innovation-by-direction to decentralized technical change.

Findings from studies in line with this argument indicate indeed that the decision making of enterprises in both the rapidly expanding nonstate sector and the traditional state sector has been increasingly responsive to the information conveyed by price movements in markets, and that much of the gains accruing to enterprises has been realized through the sales of their output (e.g., Jefferson and Rawski 1994a, 1994b; Jefferson and Singh 1999; Naughton 1995a; Rawski 1994b). What is left open to question, however, is whether the terms of trade among enterprises are determined mainly by the decisions and actions of interacting economic actors.[16] If such terms are significantly shaped by other forces (e.g., the decisions and actions of state agents) despite an expansion of self-arranged transactions between economic actors, then the potential role of markets as a screen through which to determine the relative payoffs among enterprises is severely restrained. Under such a condition, it is questionable to equate an expansion of concrete markets for products and factors to an expansion of the conceptual abstraction of market as a particular mode of economic activity.[17] Equally questionable

[16] An oft-cited example to support the economic competition argument is the growing inability of many state enterprises to enlist particularistic support from the state to protect their previously privileged status and contain their losses (see, e.g., the above quotation from Rawski). But in no way does this indicate that the better performing enterprises (especially those in the nonstate sector) do not get ad hoc favorable treatment from the state.

[17] Failure to recognize this important difference between concrete markets and the ideal-typical image of market as a mode of economic coordination and regulation appears to have led some studies (e.g., Nee 1989, 1991) to see markets and state power as mutually exclusive phenomena and conclude that in post-Mao China the rise of the former has led to the decline of the latter. For a critique of the tautological logic in the analysis developed from this dichotomized view, see Walder (1996).