Rule of Law in China: Chinese Law and Business

China's Transition: Predatory State or Developmental Autocracy?

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Executive Summary

- Minxin Pei has effectively described the resilience of China's authoritarian Communist Party and its successful strategy of 'illiberal adaptation'.

- However, Pei mis-characterizes economic policymaking and the state of the Chinese economy. China's economic transition is not 'trapped'. Instead, China has the capacity to move forward to a more sophisticated and equitable economy.

- Far from being paralyzed, economic policymaking in China has for the past decade displayed remarkable flexibility and decisiveness. The impressive rebuilding of fiscal capabilities since the mid-1990s is an accurate reflection of policy effectiveness.

- In the past few years, China's economic growth has accelerated. In part, this is because of responsive policy, but also because of the real accumulation of skills and capabilities that has accompanied China's development.

- Although China faces daunting and complex economic challenges, it has stronger capabilities to address these problems than in the past.

- Pei argues that rent-seeking and corruption are central to the regime's political and economic strategies. In fact, contemporary economic policy directly addresses the real costs of rent-seeking and corruption. Sectors in which the government is still dominant, such as telecoms and banking, have been restructured to ensure a crucial minimum of competition.

- Three recent policy initiatives attempt to increase transparency and accountability in key areas: requiring state-owned corporations to pay dividends to the state will demand greater corporate accountability; new oversight of land transactions will limit opportunities for corrupt local officials; new rural policies reduce the formal and informal burdens on farmers, while encouraging broad access to social services such as education.

- A paralyzed regime, unable to act against corrupt officials and entrenched interest groups, would not produce policy initiatives of this kind. While these policies still face opposition, they will be at least partially implemented.

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Introduction

Minxins Pei's study of China's political and economic transition is magisterial in scope and impressive in its mastery of detail. Pei argues that through a combination of selective withdrawal and reform-fostered economic growth, the Chinese Communist Party has managed to rebuild and consolidate political power. The gradual political liberalization of the 1980s has been abandoned in favour of 'illiberal adaptation', combined with selective repression and cooptation. As a result, the regime has 'the means and skills to confront … and contain the threats posed by rapid economic modernization and social change' (Pei 2006, p. 95). Thus, China's transition is indeed 'trapped', in the sense that a gradual but smooth combination of economic development and political liberalization and democratization is not on the horizon.

Analysis of the political context

In my view, Pei's description of the overall structure of Chinese politics is correct, and provides the most powerful and comprehensive view of Chinese politics to date. Indeed, even such a leader as the current premier, Wen Jiabao, who seems to be vaguely sympathetic to the need for democratization, shows every sign of believing that democratization can be indefinitely deferred. Although he displays a kind of instinctive willingness to trust and 'rely on the masses', Premier Wen nonetheless ultimately responds to each specific problem as an opportunity for a top-down technocratic fix, which unambiguously represents illiberal adaptation; rather than as an opportunity to solve problems by adopting mechanisms of bottom-up empowerment, or liberal adaptation. China's leaders appear to have concluded that authoritarian solutions are more 'efficient' than disorderly democratic processes.

In addition to his overview of China's politics, Pei gives us an extremely powerful and compelling account of China's problems. Combining lively detail with data analysis, Pei provides a highly readable account that also gets to the heart of the most important problems in China today. Corruption is accurately portrayed: both a 'central level' corruption problem, systemic in nature, and having to do with powerful central-government linked interest groups holding on to monopoly sectors with market power; and a 'local level' corruption problem that results, at its worst, in a kind of mafia state: a linkage between corrupt officials and powerful economic interests.

Pei also effectively portrays what he calls the 'governance deficit' that emerged in China during the 1990s, in which China's provision of social goods, in particular, fell behind the demands of a rapidly evolving economy and diversifying society. In particular, Pei makes good use of the wide-ranging discussions going on in China around these crucial problems. For nearly every problem, Pei adopts a penetrating, authoritative, and compelling independent voice. Pei's description of the problems, and his dialogue with scholars and analysts in China, presents the complex Chinese reality as well as possible in 200 short pages.

Analysis of the economic context

However, there is one significant area where I believe Pei is wrong. Pei argues that the achievement of economic growth in China is less than it appears, and that future economic stagnation is increasingly likely. He argues that past reform choices have backed the regime into an increasingly passive position, such that reforming policymaking is virtually paralyzed. He argues that the Chinese regime's approach to gradualist economic reform has substantial hidden costs. In arguing for economic, as well as political, stagnation, Pei seriously misinterprets a critical part of the contemporary Chinese reality.

I will argue that from an economic standpoint, the Chinese regime is not trapped, and has the opportunity and, increasingly, the resources to break out of potential traps. Furthermore, I argue that China has been engaging in a systematic process of building capabilities. While some important governance deficits have indeed emerged, Chinese society and economic systems are, as a whole, more capable, resilient, and likely to succeed than ever before. Indeed, precisely the growth of capabilities provides some basis for optimism. China's challenges are difficult and complex; but increasingly China has the means and resources to solve them. It will, however, require an increasingly open and democratic society.

Post-transition policies and capabilities

In arguing that China's economic policy is increasingly paralyzed, Pei paints the reality in reverse. In fact, Chinese economic policy is not paralyzed. Rather it has become increasingly decisive since the mid-1990s, evident in some general indicators and the specific sectors where Pei discerns particularly acute dilemmas for Chinese policymakers.

Chinese policymaking has left behind the fragmented and inconsistent policymaking that characterized the early years of economic transition until about 1993. During the first fifteen years of transition, the regime almost never displayed the capacity to override specific interest groups and impose reform-related costs on powerful groups. As a result, central government became progressively weaker. By the early 1990s, it faced a crisis of regime effectiveness. Pei accurately exploits many of the events and trends established during this era. However, he does not adequately capture the dramatic change in regime capabilities that occurred after 1993 (Naughton 2008).

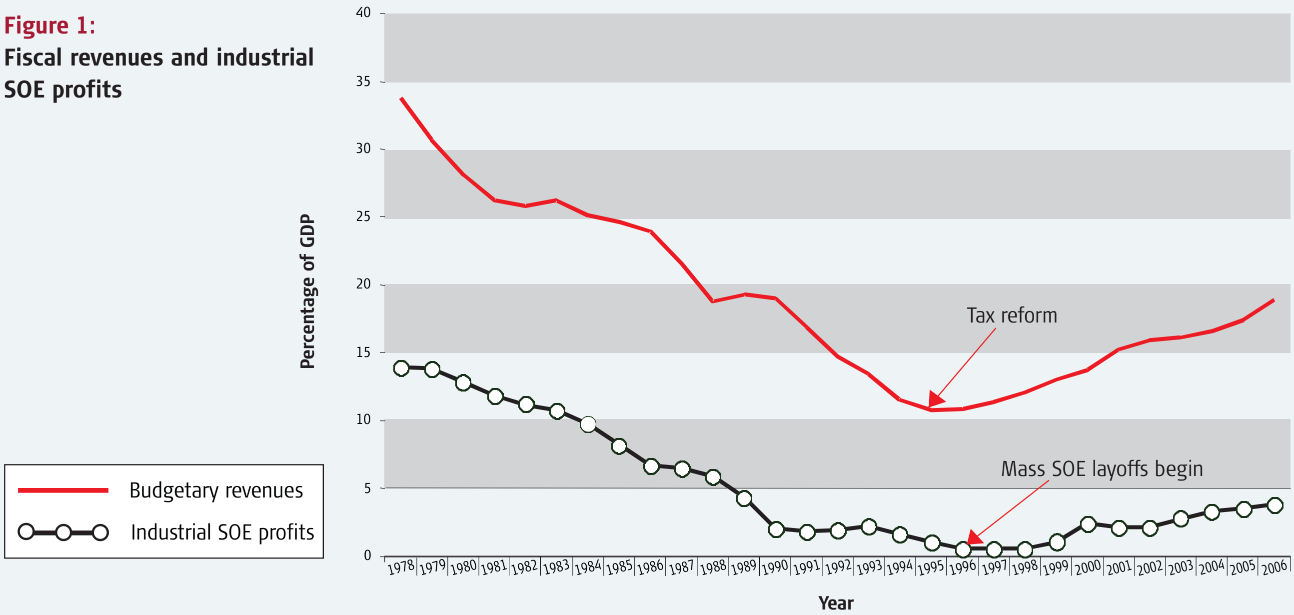
With the passing of the old revolutionary generation, the consolidation of power around a new political generation, and the progressive, though still partial, institutionalization of political processes, China's political system began to display a new decisiveness after the mid-1990s. In the language of Tsebelis (2002), the number of veto points decreased dramatically, with a resultant increase in policy decisiveness. From 1993, the regime tackled head-on many of the difficult and politically charged economic problems that it had avoided during the first fifteen years of transition.

Some of the most dramatic changes occurred when the regime finally tackled the entrenched position of state-owned enterprises (SOEs), cutting the SOE labour force by a staggering 60 per cent, removing the army from business, and abolishing the allocation of foreign exchange and the dual-tier foreign exchange system. All these measures directly confronted an entrenched interest group, removed egregious examples of rent-seeking, and, most importantly, reduced the total amount of rents in the system.

The clearest and most important index of change is in the fiscal system. Pei bases important parts of his argument on fiscal decentralization, as a characteristic of China's transition. Fiscal decentralization, however, was only a characteristic of the first period of reform, through 1995. From 1996 to 2006, budgetary revenues as a share of gross domestic product (GDP) increased dramatically and consistently: by an annual average of three-quarters of a percentage point of GDP every year. There is no evidence that the process is slowing (Figure 1, overleaf). Moreover, since the 1994 fiscal reform, central government has been the initial collector of over 50 per cent of budgetary revenues, meaning that local governments now depend on the availability of central government transfers to fund their budgets. Pei's analysis obscures this fundamental turning point.

These fiscal trends reflect comprehensively the impact of diverse economic and political trends. Because fiscal revenues and expenditures are comparatively easy to monitor, the fall and rise of fiscal revenues corresponds, to a certain extent, to a trend of rising then falling decentralized rent-seeking. Fiscal erosion comes, in part, from interest groups seizing part of the public's resources. Conversely, fiscal restoration would have been

Figure 1:
Fiscal revenues and industrial SOE profits



inconceivable unless the central government developed the ability to claw back public resources from specific interest groups.

Moreover, the ability to legitimately control fiscal resources spills over into related areas. As Pei (p. 121) argues, 'central authorities' concessions on fiscal decentralization guarantee that they will maintain centralized control over credit allocation as a vital means of regime survival'. Pei's logic is that without direct control over budgetary resources, the regime will be forced to divert credit to their key patronage projects. The logic is correct, but we should note that it is currently working in the reverse direction: rebuilding of central government fiscal resources makes it possible for the central government to relax its highly politicized control of credit resources. Indeed, shortly after the success of fiscal reform became evident, Beijing launched financial reforms that, between 1998 and the present, have transformed the financial conditions of China's banking sector.

Pei identifies three sectors, including banking, where there are particularly serious problems of rent-protection: grain procurement, telecoms, and banking. Pei sees the central government as committed to policies that protect rents owned by government organizations. He concludes that as the temptations of easy money become too great, monopoly power will inevitably lead to rent diversion and dissipation. These detailed case studies cannot be adequately discussed here, but two general observations are worth making.

Firstly, in each area, precisely because of the serious problems that Pei accurately sketches, there has been a significant change of policy and vigorous government response since the late-1990s (the bulk of Pei's argument). Secondly, in each area, we see explicit government policies that limit the degree of monopoly power, and ensure that government agents are subject to a significant amount of competitive pressure.

Pei describes the costly and dysfunctional grain procurement policy that was a personal pet project of Zhu Rongji. The flaws were manifest to virtually everyone, but Zhu refused to countenance change. As soon as the new Hu–Wen administration came in after 2002, the policy was abandoned. Today, the idea that the Chinese Communist Party state has some built-in need to extract surpluses from the peasants appears completely untenable. A whole series of policies have been established since 1999 to prop up grain prices, provide direct subsidies to grain farmers, protect farmers from WTO-triggered import competition, abolish grain tax, and increase funding for rural education and health.

These policies are not a smokescreen: they have substantially reduced the government's extraction of resources from agriculture.

In the banking sector, the government has injected enormous amounts of money, cleaned up their balance sheets, and assisted the better banks through a successful process of corporatization, attraction of strategic partners, and public listing on the Hong Kong and Shanghai markets. The government has acted strongly, generally with success, to address the problems that Pei describes.

Moreover, no single government enterprise exercises true monopoly power in any of these sectors. Granted that market power of some kind exists, and that today's rules are far from optimal or fair. But the existing set-up cannot be interpreted as a blank cheque for monopolists to carry on business as usual, without regard for competitors.
Grain procurement in the countryside is highly competitive today; and indeed was highly competitive even under the old dysfunctional policy, as Pei's account makes abundantly clear.

In telecoms, the government does protect the market power of a limited number of incumbents, maintaining the sector as an oligopoly. But the oligopolists compete vigorously on price and service. The banking sector, meanwhile, operates in a market environment in which joint stock banks have made substantial inroads into the market share of the old incumbent 'big four' state banks. Foreign banks have been allowed entry, and started taking RMB deposits from Chinese citizens from April 2007. Foreign banks are slowed by onerous regulation, and by their own calculations about strategic partnering. But everybody understands that foreign banks will eventually become powerful competitors. Where, then, is the quiet life of the monopolist, free to divert rents and line his pockets without consequences?

The specific institutional arrangements of today were set up by central government policymakers, precisely because they recognize the costs of monopolistic arrangements, and because they are eager not to dissipate their own resources, patronage, and political control to nominal subordinates who occupy strategic chokeholds on the economy. Moreover, has anyone argued that the telecoms sector is holding back the Chinese economy? Or even the electricity sector, with its formidable problems? Despite the problems of corruption and insider dealings, those involved understand that they must conform to the central government's demands, that they serve the 'scientific developmentalist' vision of the leaders. Those that do not perform to this standard will quickly lose their comfortable positions, and will not be able to collect rents for very long.

It is as well to notice the process at work here. Problems emerge and provoke vigorous public discussion. The press is not free. But it has the ability to serve as a forum in which concerned citizens can campaign against mistaken policies and egregious institutions, albeit guardedly, and without challenging Communist Party power directly.
And then what happens? When a rough consensus has emerged that a problem needs to be addressed, the central government concentrates its power and resources, and takes direct action to resolve it.

This capacity, first apparent in the mid-1990s, has since been more or less consistently in evidence. Decisive policymaking emerges in a key arena, once the clear need and priority for action has been established. This requires two stages. The first stage is vigorous discussion and debate about policies. This produces the literature that Pei utilizes. Some of the most trenchant critics that Pei cites, for example, Xie Ping in the case of the financial system, and Chen Xiwen in rural affairs, are in fact top policy intellectuals with a direct hand in making policy, who may even manage powerful government institutions in their respective sectors. Thus, the way is smoothed for the second stage, the translation into effective policy. Specialists and technocrats do have the ear of top policymakers, once there is a strong and compelling enough case for intervention. This has happened repeatedly since 1993; the system is able to override the special interest groups involved.

Economic reform, growth, and development

Let us state clearly that the problems of corruption, insider dealing, and rent-seeking are extremely serious and could indeed become obstacles to China's growth in the future. But they do not, at present, directly threaten growth and development processes. Not only has gradualist reform produced high growth; it has also produced a government apparatus which has established its credibility as an agent able to respond strongly and decisively to problems as they emerge. This is a huge resource, akin to that established by the US Federal Reserve Board. China has a trillion dollars in foreign exchange reserves, and a reputation for effective and credible policymaking. These things help to shelter the Chinese economy from the fragilities which otherwise might on occasion threaten to overwhelm it.

Meantime, China is undergoing a powerful process of economic development. Pei acutely dissects China's 'governance deficits'. But it would be wrong to assume that these 'deficits' mean that China's developmental achievements are less than they appear. Indeed, China's overall human development based on longevity, education, and purchasing power adjusted GDP has continued to climb steadily. Since 1980, in terms of average human development as measured by the Human Development Index 2003, China has gone from the level of Pakistan (0.56 on the index) to that of Turkey (0.75). That is a huge achievement, one that creates new demands and expectations. It also means that the society has significantly greater capabilities than it did a decade ago. As Deng Xiaoping put it, 'development is the only hard truth'.

Economically therefore, China is clearly not 'trapped in transition'. China's remarkable growth, export success and financial restructuring are not illusory; far from being trapped, the economy is in fact exhibiting unparalleled dynamism. All indicators of fiscal and financial soundness reached a low point around 1996–8. Since 1997, the financial health of banks, the balance sheets of state enterprises, and the revenue capacity of the government have all rebounded strongly (Figure 1). The recovery is ongoing.

Where does this strength and resilience come from? Most importantly, on the policy side, Chinese performance comes in an outstanding internal consistency of policy and ability to mobilize resources. It is not that the Chinese fiscal system is of outstanding quality, or that its financial system is highly sophisticated. Rather, each is adequate, when bound to the common goal of economic growth. Similarly, rapid economic growth is not founded on extraordinary productivity; but on a record of impressive investment, combined with adequate growth in productivity. Institutions must be of adequate quality to support the resource-mobilization effort, but they do not necessarily have to reach the standards of the economies of developed countries.

Investment, infrastructure development, and accountability

China has managed to maintain the world's highest investment rate, while mobilizing resources to restore its fiscal and financial systems, largely by running a 'low accountability' economy. Important features are the large sums of money generated internally, and the weak accountability over their use. Until 1990, state enterprises generated substantial profits available for re-investment (Figure 1). Since 1997, those profits have rebounded. In 2004, for example, total urban fixed investment was given as 590 billion yuan, 36.9 per cent of (revised) GDP. Of this total, 58 per cent was still invested by state-owned or controlled entities. Even more remarkable is the fact that 52 per cent of urban fixed investment was funded from so-called 'self-raised funds' (*zichou zijin*), which, in practice, generally means retained funds. 'Self-raised funds' are two and a half times as large as bank loans in funding fixed investment, amounting to 20.5 per cent of GDP.

These facts may be considered a weakness: the Chinese economy is still over-dependent on state-owned institutions, which generally operate at a lower level of efficiency than private ones. However, they are also a strength: the Chinese economy is capable of pouring money into rapid infrastructure development, building ahead of demand, and underpinning extraordinarily rapid growth.

So, have we reached the point where economic policy has stopped innovating, and is simply maintaining the growth engine and protecting it against challenges? On the contrary. The Chinese regime is supporting economic policies designed to achieve some of the effects of increased accountability, transparency, and equity. These policies are the most important: restructuring the state-owned corporate sector to improve accountability and deliver dividends to government; subjecting local government control of land to central government oversight and transparency; and creating a new rural fiscal system that relies on greatly expanded central government transfers to rebuild education and health systems. Each of these is underway, each is serious, and each may still fail.

One of the peculiar characteristics of the state-owned sector in China is that since 1994, when the tax and fiscal system went into operation, the government has not received profits from state firms, only taxes. At the time, state firms were bleeding red ink, and total profits were extremely small. So, as part of the implementation of the new tax system, it was simply decreed that firms have the right to retain after-tax profits. If a firm is listed on the Shanghai stock exchange, it pays dividends to individual shareholders and to share-holding legal entities including other state firms and some state agencies. However, these dividends never find their way into the state budget.

The large sums of money generated in the state sector are, at the central level, nominally under the control of the central State Asset Supervision and Administration Commission (SASAC). Central SASAC firms earned exactly 627.65 billion yuan in 2005, which amounts to a whopping 3.4 per cent of total GDP. But two-thirds of this huge sum was earned by just seven firms: China Petroleum, Sinopec and the China National Offshore Oil Company (CNOOC); China Mobile and China Telecom; COSCO; and Baogang Steel. These are Pei's rent-seekers and monopolists. It follows immediately that the central government's effort to subject these corporations to increased oversight, to make up a capital budget and remit a substantial share of profits to SASAC and the Ministry of Finance, represent a direct assault on the firms' ability to enjoy rent diversion.

Centralized dynamics, local economies

The parallel policy at a local level is the new central government land policy (Naughton 2007). In September 2006, the central government issued a new land policy (State Council Document No. 31) and created a new National Land Superintendency. The new policy requires that cities book the entire revenue from land sales as budgetary income, then record the outlays from those revenues separately as budgetary expenditures. Land may not be given away free, or sold for less than a standard published minimum price. It should only be auctioned in an open and competitive bidding process. Rural land can only be requisitioned if adequate provision is made to compensate farmers for land value, and make arrangements for their social security. Land is the most important single source of local government economic power. The willingness of the central government to challenge this key resource puts it on a direct collision course with local governments.

The central government has, over the past few years, rolled out a series of policies to reduce the tax burden on farmers, while increasing central government transfers, especially for education and health. These policies are well intentioned, and have many serious flaws. But one thing is unambiguous: they aim to fundamentally restructure the economic and political ties, not only between central and local governments, but also between rural governments and the rural population. These policies have already undermined the ability of local officials to extract fees and payments from rural residents. They now seek to create a new stream of resources into rural education and health, subject to central policy direction.

'Decentralized predatory state' or 'centralized developmental autocracy'?

Central government has promulgated policies that directly target rent-seeking by powerful government corporations, well-connected municipal government officials and rural government officials. Can this be characterized as the behaviour of a government ordained to decay as a decentralized predatory state? Are central government leaders delusional and unable to recognize that their power rests on corrupt corporate and local Party elites?

More realistically, national leaders identify their interests with national technocratic and developmental autocracy. They know that this autocracy can be successful only if it has the will and ability to override particularistic interests in the pursuit of developmental goals. Central government is certainly neither all-powerful, nor able to impose policies without regard for local interests. Nevertheless, over the past decade, the central government's record of policy implementation has been fairly good. It now has money, power, and direct control over promotion within the hierarchy. The fall of Shanghai Party Secretary Chen Liangyu was a case in point.

Ultimately, China today is more of a centralized developmental autocracy, than a decentralized predatory state. Developmental autocracies may indeed be anomalies, as Pei argues (p. 44). But these anomalies seem to occur disproportionately in Chinese-speaking economies. Based on their experience over the past few years, China's developmental autocrats are not likely to decide they have done a bad job and should step down. Illiberal adaptation is the name of the game today and in the immediate future. One might argue that the problem is not that China is too decentralized and predatory; rather that the central leaders, having encountered a phenomenal run of economic success, have increased confidence in their own ability to manage and steer the next phase of development.

Conclusions

At some point, transition to the first tier economies will require something better. It is impossible to imagine China becoming a first-rate economic power without a stronger set of institutions, an improved property rights regime, and a system of accountability that ties economic decisions and risk more firmly to individual decision-makers. But how will this transition take place?

From the beginning, doubts about the economic sustainability of China's transition have been embedded in political concerns. Is it plausible that the Chinese Communist Party would be willing to undertake institutional changes of the magnitude required to create a market economy? As the Chinese economy moves further away from economic crisis, will the autocrats become more or less likely to cede power?

Finally, will China's growing private business sector, accorded full legitimacy just five years ago, become a factor in political decision making? The crucial decisions of the next few years will not be made solely on economic grounds. There are still many different approaches to the economic challenges that might plausibly promise success. Instead, as Minxin Pei argues, those decisions will be made on political grounds.

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