

**Rule of Law in China: Chinese Law and Business**

# Is China's Transition Trapped and What Should the West do about it?

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## Executive Summary

- After nearly three decades of economic reform, China's transition to a full market economy and liberal democratic political system, which those believing in the linkage between economic modernization and democracy had hoped for, appears to have stalled.
- The country's ruling party, the Chinese Communist Party, has demonstrated a remarkable capacity to resist democratic change. The strategy of gradual economic reform, heralded by many as a superior approach to transforming state socialism, has failed to remove the state's presence from key sectors, whilst incurring high transition costs. Widespread corruption indicates that the Chinese state may no longer be developmental in nature, but predatory.
- This policy brief attempts to challenge three popular views on China:
  - Firstly, it contends that it is the political calculation of the ruling elites, rather than the process of modernization, that determines the pace of political liberalization. By examining how Chinese ruling elites view political reform and adapt to socio-economic change, it argues that economic growth can retard political liberalization in the short term.
  - Secondly, the brief argues that the imperative to preserve the political monopoly of a one-party system overrides the desire for a fully marketized economy; and determines the strategy of economic reform. This perspective provides an understanding as to why the Chinese government has opted for gradualism in reform, and why such a process has enabled the ruling elites to protect the most critical economic sectors from market competition.
  - Thirdly, instead of fostering a developmental state, the combination of one-party rule and semi-finished economic reform creates fertile conditions for local ruling elites to engage in decentralized predation, undermining governance and creating systemic risks.
- In conclusion, such 'partial reform equilibrium' is ultimately unsustainable. But it is impossible to predict how China can break out of this 'transition trap'. The international community must re-examine its assumptions about China's future. It must be prepared for the consequences of deteriorating governance and rising social strife caused by China's trapped transition.

## Is China's Transition Trapped and What Should the West do about it?

As China's economic reforms enter their fourth decade, Western analysts have grown increasingly divided in their assessments of the country's future prospects. Certainly, in the past three decades, China has proved many doomsayers wrong. Instead of buckling under the strains of economic growth and social dislocation, China has prospered. But China's apparent economic success has not laid to rest debates about the country's future. Generally speaking, four perspectives evaluate the future trajectory of China.

### **One country, four perspectives** *Liberal evolution*

The first and perhaps dominant perspective, of which China is a prime example to many observers, may be called 'liberal evolution'. By this process, economic changes eventually lead to the emergence of rule-based market institutions and political democratization. China is repeating the 'East Asian model' of development in South Korea, Taiwan, and Thailand that has proved its efficacy in economic growth and eventual democratization.<sup>1</sup>

Thus, some economists and analysts cite China's progress in financial sector reforms, the restructuring of state-owned enterprises, the de-collectivization of agriculture and the establishment of various regulatory institutions as evidence that China is

moving toward a market economy underpinned by robust state institutions.<sup>2</sup>

In the political realm, some observers have also detected movement towards a more liberal political order.<sup>3</sup> Three factors are cited as having provided the momentum for political change. Firstly, bottom-up pressures from a citizenry, economically better-off and increasingly conscious of its rights, have forced the authoritarian Chinese system to become more responsive and accountable.<sup>4</sup> Secondly, through reducing the role of the state and introducing new technologies of communication, economic reform and modernization have created more public space and allowed greater press freedom, societal autonomy and alternative forms of political participation.<sup>5</sup> Thirdly, top-down institutional reforms initiated by the regime, however limited they have been, have contributed to institutional pluralism, the rule of law, and grass-roots democracy.

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1. On the 'East Asian model', the best works are:  
The World Bank (1993) *The East Asian Miracle: Economic Growth and Public Policy*. Oxford: Oxford University Press.  
Wade, R. (1992) *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton: Princeton University Press.  
Peerenboom, R. (2007) *China Modernizes: Threat to the West or Model for the Rest?* Oxford: Oxford University Press.

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2. The most representative works arguing this position include:  
Naughton, B. (1995) *Growing out of the Plan: Chinese Economic Reform, 1978-1993*. Cambridge: Cambridge University Press.  
Yang, D. (2004) *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China*. Palo Alto: Stanford University Press.  
3. Ogden, S. (2002) *Inklings of Democracy in China*. Cambridge (MA): Harvard University Press.  
4. Goldman, M. (2005) *From Comrades to Citizens: The Struggle for Political Rights in China*. Cambridge (MA): Harvard University Press.  
Li, L. and O'Brien, K. (2006) *Rightful Resistance in China*. Cambridge: Cambridge University Press.  
Perry, E. and Selden, M. (eds) (2003) *Chinese Society: Change, Conflict, and Resistance*. London: Routledge.  
5. Zhao, Y. (1998) *Media, Market and Democracy in China: Between the Party Line and the Bottom Line*. Champaign (Ill): University of Illinois Press.  
Shi, T. (1997) *Political Participation in Beijing*. Cambridge (MA): Harvard University Press.  
Davis, D. et al. (eds) (1995) *Urban Spaces in Contemporary China: The Potential for Autonomy and Community in Post-Mao China*. Cambridge: Cambridge University Press.

These reforms have yet to turn China into a democracy; but they have laid institutional foundations for future progress. In particular, three specific institutional initiatives have been singled out as representing regime-sponsored political reform: the strengthening of the legislative branch, legal reform, and village elections.<sup>6</sup> These positive developments have even led some observers to predict the inevitability of democracy in China.<sup>7</sup>

### *Authoritarian resilience*

The second perspective may be called 'authoritarian resilience'. Proponents of this perspective are more sceptical of sanguine assumptions about the inevitability of political liberalization induced by economic progress. Instead of seeing a future of liberal democracy in China, this small group of analysts believes in the theory of authoritarian adaptation and resilience. Based on the perspective of resilient authoritarianism, it is unlikely that China will evolve into a liberal democracy. Instead, the current rule of the Chinese Communist Party (CCP) will endure, because the ruling party has acquired adaptive skills and greater institutional capacity for political survival.

In particular, scholars who see resilient authoritarian rule in China identify three important trends as indicative of the CCP's growing adaptive skills and political capacity. Firstly, they argue that the CCP has successfully overcome the most difficult challenge for all authoritarian parties: the question of succession. The party has developed and consolidated rules for selecting, training, and promoting elites. In addition, through homogenizing political socialization and a

preference for technocracy, the party also boasts a well-educated and technically capable bureaucracy, skilled in problem-solving. As a result, the party today has achieved an unprecedented unity of the elite and technocratic competence.<sup>8</sup>

Secondly, the party has successfully co-opted new social elites, especially the urban intelligentsia and private entrepreneurs, two social groups commonly regarded as gravediggers of authoritarian rule. Such co-optation has broadened the social base of support for the CCP, while depriving potential anti-regime movements of essential counter-elites.<sup>9</sup> Thirdly, the party has exploited nationalist sentiments within the Chinese population to strengthen its own political legitimacy. As a result, with its original Marxist-Leninist ideology all but bankrupt, the party has found a new source of political legitimacy, especially among the younger and better educated urban generation.

### *Imminent collapse*

The third perspective is shared by a tiny minority of China observers who think that CCP rule is in danger of 'imminent collapse'. Although proponents of this perspective have little influence in the academic community, they frequently attract much media attention. Contradicting both perspectives of liberal evolution and resilient authoritarianism, the 'imminent collapse' perspective focuses on the political decay, moral bankruptcy, rising social unrest, erosion of state authority, and financial distress within the Chinese system. Analysts who examine China from this perspective believe that the CCP is too corrupt to regain its lost political legitimacy, or

6. Peerenboom, R. (2002) *China's Long March toward Rule of Law*. Cambridge: Cambridge University Press.

Tanner, M. S. (1999) *The Politics of Lawmaking in Post-Mao China: Institutions, Processes and Democratic Prospects*. Cambridge: Cambridge University Press.

Diamond, L. and Myers, R. (eds) (2001) *Elections and Democracy in Greater China*. Oxford: Oxford University Press.

7. Gilley, B. (2004) *China's Democratic Future: How it Will Happen and Where it Will Lead*. New York: Columbia University Press.

8. Nathan, A. J. (2003) 'Authoritarian resilience'. In *Journal of Democracy* 14:1, January.

Li, C. (2001) *China's Leaders: The New Generation*. Lanham (MD): Rowman and Littlefield.

Naughton, B. J. and Dali, L. Yang (eds) (2004) *Holding China Together: Diversity and National Integration in the Post-Deng Era*. Cambridge: Cambridge University Press.

9. Dickson, B. (2003) *Red Capitalists in China: The Party, Private Entrepreneurs, and Prospects for Political Change*. Cambridge: Cambridge University Press.

to manage China's enormous domestic challenges. Despite its outward strengths, the ruling party is too brittle to survive a major political or economic shock.<sup>10</sup>

### *Authoritarian stagnation*

The fourth perspective, which may be called 'authoritarian stagnation', is most comprehensively developed in this author's *China's Trapped Transition: The limits of developmental autocracy*,<sup>11</sup> rejecting the optimistic and deterministic assumptions of the liberal evolution perspective. The ruling elites are unlikely to willingly surrender power as long as they reinvigorate their legitimacy with ostensibly superior performance; increasing economic resources also allow the autocratic regime to co-opt new social elites and preempt anti-regime social movements. To some extent, the perspective of 'authoritarian stagnation' shares the view about the adaptive capacity of the CCP found in the 'resilient authoritarianism' perspective; both agreeing that the ruling party has learned to adapt to the social and political consequences of rapid economic change, especially by adopting new and more effective tactics of control and repression.

However, the 'authoritarian stagnation' perspective fundamentally disagrees with the view that Chinese authoritarian rule is 'resilient'. It may be resilient only in terms of suppressing anti-regime forces. But the authoritarian rulers are inherently incapable of restraining the predatory behaviour of the lower-level elites in the system, who enjoy unprecedented discretionary power and a near total lack of accountability.

The self-destructive dynamics of predatory authoritarianism pose the most lethal threat to the long-term survival of the CCP. Indeed, many of the familiar pathologies in the Chinese political and economic systems are rooted in the predatory nature of the ruling regime. Today, such pathologies are manifested in numerous social problems, such as environmental decay, rising inequality, declining state capacity, and the emergence of local mafia states. To the extent that autocratic elites lack institutional mechanisms to contain decentralization predation, no authoritarian regime can maintain its resilience.

The 'authoritarian stagnation' perspective also differs from that of 'imminent collapse' in that it holds that current ruling elites still enjoy an overwhelming preponderance of power vis-à-vis any potential challengers. The Chinese state controls a vast apparatus of internal repression that has demonstrated impressive capabilities in suppressing, containing, and preventing large-scale organized opposition or protest movements. At the same time, strong economic momentum, derived from China's high savings, openness to trade, mass labour migration, and societal entrepreneurship, are likely to offset the growth-dampening effects of the bad governance and systemic inefficiency of the current regime. Therefore, on balance, as the more likely outcome, the 'authoritarian stagnation' perspective forecasts a gradual dissipation of vigour and momentum, rather than sudden collapse.

### *Is China's transition trapped?*

These four perspectives are not merely theoretical discussions among academics. They inform policy and have consequential implications. This section analyzes why the 'authoritarian stagnation' perspective may fit the Chinese reality better than the three other contending theories.

The central thesis of authoritarian stagnation is that China's transition from a quasi-totalitarian political system and state socialist economy to a liberal democracy and market economy has lost momentum; and is trapped in a 'partial reform equilibrium'. During this intermediate stage of reform, while a

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10. Chang, G. (2001) *The Coming Collapse of China*. London: Random House.

Goldstone, J. (1995) 'The Coming Chinese Collapse'. In *Foreign Policy*, Summer.

Schell, O. (2002) 'Red herring: Special Report: China - The Coming Collapse', November 7.

Waldron, A. (1995) 'After Deng the Deluge'. In *Foreign Affairs*, September/October.

11. Harvard University Press (2006).

reversal of previous reforms is unlikely since the ruling elites themselves benefit from partial reforms, undertaking new and more radical reforms, especially political ones, is impossible, because reforms will undermine the power and privileges of the ruling elites.

This pessimistic perspective is based on three insights derived from the theories of democratic transition, economic reform, and the state. In the literature on democratic transition, modernization theory has provided a useful guide to the economic and social conditions under which societies become democratic. Choice theory posits that the political calculus of the ruling elites determines when societies become democratic. Thus, it is a more powerful tool for understanding why some societies become democratic, while others do not, at the same level of economic development. Choice theory fundamentally contradicts the unidirectional optimism of modernization or 'liberal evolution' theories.

According to the choice perspective, economic development will not necessarily bring democratic change, so long as the ruling elites have the will and capacity to resist such change. To the extent that ruling elites remain determined to preserve authoritarian rule, economic development may actually provide these elites with the resources to neutralize the political effects of rapid socio-economic change. Through learning and adaptation, authoritarian ruling elites can tap into the growing financial resources of the state to strengthen their repressive capacity and co-opt emerging social elites. The result is economic development without democratization.

Choice theory also helps us understand the political calculation behind the decision of the ruling elites to engage in economic reform; and their strategies in pursuing such reforms. While mainstream theories of economic transition focus on the maximization of efficiency gains under political constraints, choice theory directs attention to the authoritarian regime's overriding imperative to preserve political power during economic transition. The maximization of efficiency gains undercuts the ruling elites' ability to

preserve political power; and choice theory posits that ruling elites would readily sacrifice efficiency gains, in order to maintain their political monopoly.

Under such conditions, economic reform must assume the form of gradualism, since such a course of action maximizes the ability of the ruling elites to keep the economic foundations of their political monopoly from being eroded or destroyed by market reforms. The implications of this insight do not bode well for the prospects of gradual economic reform under authoritarian rule. Autocratic rulers prefer a semi-reformed and inefficient economic system, optimized to preserve their power, to pursuing genuine market-oriented reforms that would undermine their power base. As a result, economic reform will inevitably fall into a 'partial reform equilibrium'.

The theory of the predatory state sheds the last light on how a political and economic transition process may become trapped. The theory of the developmental state ignores the predatory instincts of authoritarian ruling elites. It takes as given such elites' desires to promote economic development as a means of regime survival. The literature on the predatory state, however, questions such sanguine assumptions about the state.<sup>12</sup> During economic and political transitions, the misalignment in interests between the state and its agents may increase due to higher uncertainty about the viability of the regime, decentralization of property rights, new exit options, and weakening organizational norms.

These factors are likely to exacerbate principal-agent problems, giving rise to decentralized predation. Once a transitional process encounters decentralized predation, corruption becomes impossible to control. Resources are systematically diverted into the pockets of individual state agents, most of whom are engaged in a collusive alliance: the optimal survival strategy in decentralized authoritarian regimes, in which vertical accountability is extremely weak due

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12. Olson, M. (2000) *Power and Prosperity*. New York: Basic Books.

to the asymmetry of information, lack of democracy, and suppression of civil society. The implications of predatory state theory are dire for transition societies: unless restrained by the rule of law, democratic politics, and civil society, decentralized predation will drain the state's resources, enrich rapacious government officials, and cause governance to deteriorate.

A growing body of evidence has provided empirical support for the theoretical perspective of 'authoritarian stagnation'.

### *Stagnant political reform*

Contrary to the predictions of liberal evolution, recent developments in China suggest that the ruling Communist Party has become more resistant to democratic reform, despite rapid gains in economic development achieved since the 1990s. The most promising developments of the 1980s and 1990s have either slowed significantly, or ground to a halt completely. These include the strengthening of the National People's Congress as an autonomous and representative branch of the government, the strengthening of the rule of law, the expansion of grass-roots democracy beyond the village level, and the growth of civil society.

Indeed, in recent years, the political atmosphere has grown more hostile to democratic transition, as the government, fearful of a repeat of the so-called 'colour revolutions', has intensified its control over the Chinese media, nongovernmental organizations, and the Internet, and of internal dissent. In the meantime, long-awaited liberal reforms of key political institutions, such as the courts, legislature, and the electoral system, have failed to materialize. Evidence also suggests that the CCP, bolstered by the increasing financial resources generated by economic growth, has grown increasingly sophisticated in deploying a two-pronged strategy of selective repression and political co-optation. With massive investments in anti-riot police, including providing the People's Armed People with more than 250,000 officers and soldiers, Internet censorship technologies, and other tools of domestic political

control, the Chinese government has built an apparatus highly capable of suppressing any organized challenge to its authority. At the same time, the government's efforts to co-opt social elites such as the intelligentsia, professionals, and private entrepreneurs appear to have paid-off. Today, the ruling party's relationship with these social elites remains close, and is fortified by political and economic favouritism.

### *Lost momentum in economic reform*

Despite – or perhaps because of – successive years of double-digit growth, the pace of economic reform has visibly slowed, especially in the areas of privatization of large state-owned enterprises and de-monopolization. As observed by leading economists, China's reform strategy has been 'growing out of the plan'. Certainly, this strategy has delivered huge benefits, as evidenced by the relative shrinkage of the state sector. Yet, 30 years after the beginnings of the reforms, the state sector maintains its dominant role in the Chinese economy. Even though the nominal share of the state sector is, depending on the measurements used, 35 to 40 per cent of GDP, the role of the state is far more influential than this measure suggests.

Firstly, the state controls the financial system. It sets the most important price: credit. This factor alone can produce huge distortions in the economy.<sup>13</sup> Secondly, the state maintains control of another critical input: land. It enforces an onerous regulatory system that stifles competition. Thirdly, the state maintains effective monopolies in the most important sectors, such as telecommunications, energy, aviation, petrochemicals, transportation, and natural resources. Judging by recent announcements in Beijing, the government appears determined to hold on to these critical sectors and prevent foreign firms from penetrating them.

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13. Although the government does not include financial services in its list of strategic sectors, financial services are effectively monopolized by the state.



### *The rise of a decentralized predatory state*

As predicted by predatory state theory, the agents of the state tend to abuse their official power for private gains when such power is unconstrained and unaccountable. During economic transition, predation by the state is more likely to be decentralized, due to decentralization of decision-making and property rights necessitated by reform. Consequently, local ruling elites acquire unprecedented discretionary powers over the use and disposal of state properties and resources, especially tax revenue, land, and bank credit. Inevitably, this creates huge opportunities for self-enrichment.

Three additional factors further exacerbate decentralized predation. Transition increases uncertainty about the future, reduces the time horizon, and increases the 'discount rate' of government officials, who have greater incentives to line their own pockets whilst remaining in power. The availability of exit options, for example, the private sector or emigration overseas, provide corrupt officials ready escape routes and safe havens to hide their ill-gotten wealth. The disappearance of ideological norms has removed the 'first normative line of defence' against graft.

Unsurprisingly, corruption has become pervasive throughout China. Each year roughly 100,000 party members and officials are punished for corruption; although only about three per cent of them are criminally prosecuted.<sup>14</sup> Decentralized predation exhibits many insidious forms, such as collusion among and between officials and organized crime, the 'sale and purchase' of government appointments by officials, and the systematic looting of state assets by the privileged and well-connected few, including the children of the ruling elites.

### *Policy implications*

Trapped transition in China has profound implications, both for China and the West. Within China, the continuation of the status quo will lead to an accumulation of social strains and governance deficits, such as rising inequality, pervasive corruption, deterioration in social services, and worsening environmental decay. Trapped transition will breed the seeds of future instability and drain current economic dynamism. Eventually, trapped transition or partial reform equilibrium will not be stable or sustainable.

Stagnant transition in China also affects relations between China and the West. If the status quo continues unchanged, the West will grow more sceptical about the rationale of engagement; since even sustained economic engagement and political dialogue with the Chinese government have proved ineffective in promoting democratization in the country. A stagnant China under authoritarian rule will not become a full and trusted partner of the West. It poses different challenges. Obviously, the West's optimistic forecast of China's future growth needs to be revised downwards in light of the internal weaknesses. China is unlikely to become a superpower in the twenty-first century; so there is less need to engage in a policy of strategic hedging against Beijing.

This leads to a third policy option between engagement and strategic hedging; a new approach which might be called 'critical engagement'. Such a policy will maintain the overall approach of economic and political engagement; but will increasingly regard promoting internal political and economic change in China as a top priority for the West, rather than soliciting international cooperation from Beijing. While respectful of China's tremendous achievement in poverty alleviation and economic development, a policy of critical engagement will not shy away from areas of fundamental disagreement between the West and the Chinese government; especially in human rights, the rule of law, and democracy.

14. The Central Discipline and Inspection Commission announced that in 2006 the CCP punished 97,260 individuals for 'violation of the Party's rules'. But only 3530 were prosecuted. <[www.chinanews.com.cn](http://www.chinanews.com.cn)>, last viewed 14 February 2007.





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