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András Székely-Doby

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Why Have Chinese Reforms Come to a Halt? The Political Economic Logic of Unfinished Transformation

ANDRÁS SZÉKELY-DOBY

Abstract

This study approaches the Chinese reform process from a political-economic point of view, focusing primarily on institutional changes. Besides revealing the main factors behind the different phases of the reforms, it argues that in the framework of the current authoritarian regime, vested interests work against the continuation of the reforms, making it impossible to fully establish the institutional framework of a market economy. Current rents and privileges also deter the elite from implementing serious political reforms, leading to a trap that prevents the completion of the transition process.

THE TRANSFORMATION OF THE CHINESE ECONOMY SINCE 1978 has been breathtaking. From a poor, underdeveloped country, China has become one of the most important players in the world economy with a GDP surpassed only by that of the United States, an unparalleled export performance and a growth rate of around 10% (see Figure 1).¹ Its planned economy has been gradually replaced by a distinctive capitalist system, in which the state has preserved its significant controlling and regulating role. Corruption and rent-seeking behaviour have become widespread, while the political system has remained largely intact, preserving the CCP's monopoly of power and its ability to shape social and economic processes.

The first phase of the reforms (1978–1993) was characterised by a rapid growth of the market sector, a growing number of Township and Village Enterprises, and decentralised decision-making and financing practices. The reform process, which experienced a setback after the Tiananmen suppression of dissent, was reignited in 1993, but took a very different direction than in the 1980s. The previous rural orientation of the reforms and the spread of private enterprises was changed to a strategy of embracing, transforming, and developing state-owned enterprises (SOEs) in the most important industries into national flagship companies. The economy as a whole underwent a process of centralisation, while higher

¹According to the World Bank, China's GDP in 2013 (at Purchasing Power Parity) was US\$16,158 billion, in contrast to the US\$16,800 billion performance of the US. The sum of its goods and services export was US\$2,440 billion, which is around 10% of world trade (The World Bank, DataBank, World Development Indicators, available at: <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>, accessed 30 January 2018).

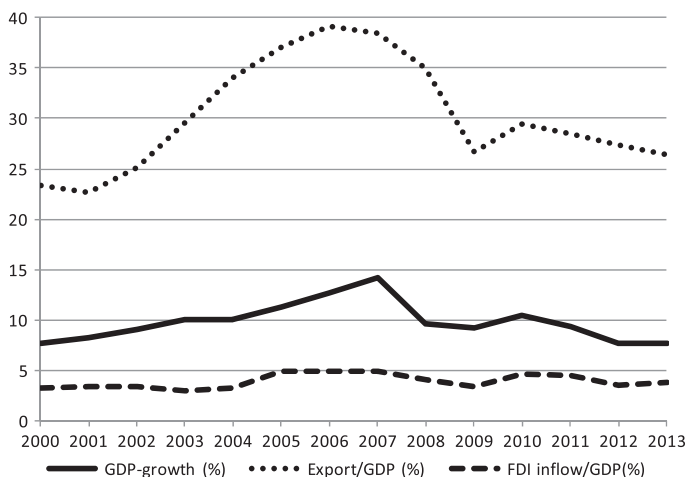


FIGURE 1. MACROECONOMIC INDICATORS FOR CHINA AFTER THE MILLENNIUM

Source: 'World Development Indicators', DataBank, The World Bank, available at: <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>, accessed 30 January 2018.

tax rates, administrative entry barriers against private enterprises, and the state-controlled financial system continued to have an adverse effect on economic efficiency.

Under the leadership of Hu Jintao (2002–2012), the reform process slowed down significantly. Some experts refer to this period as the 'lost decade' (Shambaugh 2013), during which political suppression and social tensions increased and the maintenance of stability became more and more difficult (Pei 2014). Why did this change happen? What kind of factors contributed to the slowdown of the reforms? And, lastly, is there any chance that the reform process will continue? The answers to these questions lie in the institutions shaping the functioning of the political and economic systems, the institutional competition inside the elite (Naughton 2008; North *et al.* 2009), and the incentive structure influencing the decisions of different political groups. The path, the strategy, and the outcomes of the reforms are thus determined by the political and economic institutions of the country (Xu 2011), which are shaped by the Chinese Communist Party (CCP).

This article reviews the main causes behind the start of the reform process in the late 1970s, the changes in the interests and payoffs of the players as the reforms advanced, and the possible future of the reforms in the second and third decades of the new millennium. The processes will be investigated from a political economic point of view, building on the concepts of the socialist system; reform socialism; and the change of systems. We will make use of theories dealing with historical and political determinants of the transformation, and studies examining the specific Chinese aspects of the reform process.

The results of this analysis show that in the framework of the current authoritarian regime, continuously changing interests work against the continuation of the reform process and inhibit further development of key market economy institutions, such as a sound financial system or a level playing field for competing companies. The current system of rents and privileges creates incentives for the elite to maintain the *status quo*, and to refrain from implementing new reforms. This creates a kind of trap, in which the transformation process

cannot be completed and the conditions of a sustainable, long-term development cannot be reached. The halt of the Chinese reform process thus has deep systemic causes, which this article will explore and explain.

The first part of the article presents the theoretical foundations of its argument by investigating the logic of institutional change in an authoritarian environment and identifying a specific boundary that limits the possible actions of the party leadership regarding the implementation of reforms. Different approaches to reform, system change, and transition will be examined and a central argument articulated: why a halt in the reform process is inevitable sooner or later. The second part of the article links theoretical results to the Chinese reform process, focusing on the interests and circumstances that determined the beginning of the reforms; the direct and indirect consequences of the steps taken in the first and second phases; changes in creating and allocating rents; and the systemic causes of the slowdown and the probable halt of the transition process. The article ends with some concluding remarks.

Political economic considerations

Institutional changes in authoritarian systems

In modern societies, formal institutional changes occur in the political arena, and the main contributor is the incumbent political group (party or coalition of parties).² In the process of institutional change, however, there is a huge difference between democratic and authoritarian systems. While in the former, a race for votes takes place between political parties, in the latter there is no race, no competing parties, the elite is not constrained by the rule of law, and the most important struggles take place inside the ruling party. Because political decision-making is a monopoly of the party (there is only one party with real power), institutional change can take place only under the supervision of the party. Therefore, to understand the process of institutional change in authoritarian systems, one should first analyse the operating mechanisms of the incumbent party.

In authoritarian systems, the political elite maintains its power by constraining access to valuable resources, which generates significant rents for them (North *et al.* 2009). The distribution of rents is a central problem both in regard to the outcome of political struggles and to the stability of the whole system. If the utility from rents for the competing groups (factions) in the elite exceeds the potential utility coming from an abrupt and possibly violent change of the actual power structure, the coalition remains stable. If, however, it is worthwhile for some groups to force changes in the actual power structure, a redistribution of rents will occur. This outcome can be reached either by violent or by peaceful means; the choice depends on the characteristics of the political system. The more peaceful, and perhaps more usual, way to restructure the rewards is to change the rules of the game, that is, the institutions. The political struggle between different groups of the elite then aims at restructuring the institutional setup, and the winners implement their preferred configuration. To do this, however, they need strong

²In this article we use North's concept of institutions: 'institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction' (North 1990, p. 3).

supporters. This leads to the practice of coalition-building and clientele formation (Kitschelt & Wilkinson 2007; Tang 2011),³ achieved by the distribution and redistribution of rents.

The dominant coalition in authoritarian systems has a common interest in maintaining the monopoly of power. Its main goal is neither to maximise a theoretical social welfare function, nor to fulfil the will of the people, but to preserve its leadership position.⁴ In contrast to democratic regimes, where processes of acquiring and losing power both occur within the framework of the system, losing power in an authoritarian environment could mean the end of the whole system. Therefore, the requirement of maintaining the power structure determines and limits the actions available to the dominant coalition, including potential institutional changes. From the set of potential institutional changes, the elite will choose only those that do not endanger the most important foundation of the system: the monopoly of power of the incumbent group (coalition or party). This constraint, which we will refer to as a 'preselection criterion',⁵ limits the choice of actions and appears as a negative condition: all choices that could pose a threat to the rule of the elite must be eliminated. When applying the preselection criterion, the question is not what kind of measures may bring more votes, but rather, which ones create less dangerous potential enemies. The preselection criterion, therefore, means the upper limit of the political elite's willingness to take risks, and depends on the assessment of potential threats coming from institutional changes made by the coalition.

By introducing the preselection criterion, one may describe the process of institutional change in an authoritarian environment more exactly. As indicated in Figure 2, assuming that the monopoly of power resides with a single party, the leaders always take into account the preselection criterion, considering only such changes that presumably do not threaten their power. The selection process of the potential institutional changes through political struggles, coalition-building, clientele formation, and rent creation may start only after this. At the end of the process, party leaders implement the winner's vision.

Reforms, change of systems, and transformation

The logic of the previous section helps us to understand how institutional changes occur in an authoritarian system. One particular type of authoritarian system is the socialist system (Kornai 1992, p. 10).⁶ Due to severe inefficiencies, the accumulating difficulties forced some reform steps in almost all socialist countries.⁷ The need to reform put the communist parties

³Tang originally distinguishes five phases: generation of ideas for specific institutional arrangements; political mobilisation; the struggle for power to design and dictate specific institutional arrangements (that is, to set specific rules); the setting of the rules; and legitimatisation, stabilisation, and reproduction (Tang 2011, p. 34).

⁴Regarding the socialist system, this feature is made explicit by Kornai: 'once the party has seized power and become its sole possessor, it must never relinquish it under any circumstance In the official ideology's system of values, power is no mere means of attaining other primary objectives; it becomes in its own right a primary good of intrinsic, ultimate value' (Kornai 1992, pp. 59–60).

⁵We have chosen this name because the application of the criterion in the evolutionary process of institutional changes (Tang 2011) occurs prior to the phase of selection; and before competition begins between institutional solutions inside the dominant coalition.

⁶As explained here below (footnote 8) Kornai is referring here to a system in which a Communist (or 'Marxist–Leninist') party holds a monopoly on power. Inside such systems, however, the term 'communist' is used to denote the unattained Utopian society of the future; the present system is referred to as 'socialist'. Kornai thus speaks of a 'socialist' rather than 'communist' system.

⁷According to Kornai, the four most important motivators of reform are: an accumulation of economic difficulties; public dissatisfaction; loss of confidence by those in power; and outside example (Kornai 1992, pp. 383–86).

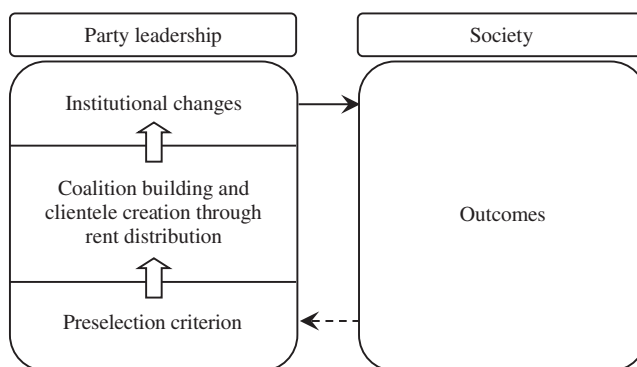


FIGURE 2. SCHEME OF INSTITUTIONAL CHANGES IN AUTHORITARIAN SYSTEMS

under constant pressure, because a stagnating economy would fuel political and social tensions that might threaten stability.

‘If such economic reforms engender deeper changes that result in the permanent and essential alteration of at least one out of Kornai’s first three blocks⁸ yet leave the Marxist–Leninist party’s monopoly of power intact, the notion of reform socialism applies’ (Kornai 1992). If, however, changes go further and the primacy of state property and bureaucratic coordination is replaced by the dominance of private property and market coordination, a change of systems occurs: either the political system is democratised or the communist party gives up its hostile attitude towards capitalism while maintaining its political rule (Kornai 2000).⁹ This change of systems exceeds reform socialism because it involves changes in the political system as well.¹⁰ Which variant is chosen depends on the characteristics of the party-state system (Csanádi 2005);¹¹ the party’s ability to manage rents, by which it may be able to maintain its monopoly of power; and the presence and strength of internal and external forces (that is, international pressures or strong opposition powers). We will call this first variant of system change—whereby the process takes place under the surveillance of

⁸These blocks are as follows: undivided power of the Marxist–Leninist party (block 1); dominant position of state and quasi-state ownership (block 2); preponderance of bureaucratic coordination (block 3) (Kornai 1992, p. 361).

⁹The process can be considered completed only after the necessary change has occurred in block 1 (see the previous footnote), namely, that the political sphere has become conducive to private property, and market-friendly (Kornai 2000, p. 33). Evidently Kornai does not assume a connection between the change of systems and democratisation; he demands, however, that those in power not be hostile to fundamental institutions of capitalism. It is, therefore, a very important step by the communist party to abandon its anti-market and anti-private property stance, because without this, the ideological position of the political elite and the prevailing economic conditions would be irreconcilable.

¹⁰This scenario can only occur if, as a result of reforms, it is already not (or only at the expense of severe sacrifices) feasible for the party to maintain the monopoly of power, or if the party leaders, taking advantage of their favourable position, can acquire sufficient stakes in the new system that justify abandoning their privileges. The latter process is discussed by North *et al.* (2009) in detail.

¹¹These two versions can be basically identified with the ‘self-withdrawing’ and ‘self-disintegrating’ variants of the party-state system transformation in Csanádi (2005, p. 178), while if the party intensifies repression instead of reforms, the ‘self-exploiting’ form of the party-state dissolution occurs.

the communist party and no democratisation occurs—‘continuous transition’, and turn our attention to this phenomenon.¹²

Even if the change of systems succeeds, and a truly capitalistic system emerges, it is not at all certain that long-term social objectives, such as sustainable growth or continuous innovation, will come into play. These objectives would require institutional conditions such as the protection of private property rights, impartial rule of law, and a level playing field for economic participants in transactions and agreements (Acemoglu & Robinson 2012). Creating and providing these conditions requires a deeper social transformation, which includes the change of systems but also exceeds it. Acemoglu and Robinson (2012) argue that differences in economic performance are the consequence of different institutions. Some institutions allow members of society to make decisions freely and fulfil their inherent potential, while others prohibit them from doing so. The former type is called an ‘inclusive institution’, while the latter, which helps the elite to extract income and wealth from certain groups of a society to maintain power, is an ‘extracting institution’ (Acemoglu & Robinson 2012, pp. 73–6).

It is evident from Figure 3 that even after continuous transition has occurred, the task of building up inclusive institutions is only half done. The other half of the process—transforming the political system (‘democratisation’)—requires further steps. Although the communist party has to abandon its ideological (Marxist–Leninist) stance, this turn does not fundamentally influence the institutional structure or the functioning of the political system. Democratisation is described by North *et al.* (2009) as a transition from a ‘limited’ to an ‘open access order’. In order to complete this process, North *et al.* (2009, pp. 151–54) argue that society first has to meet the so-called ‘doorstep conditions’: rule of law for elites; perpetually lived organisations in the public and private spheres; and consolidated control of the military. Thereafter, the personal privileges of certain members of the elite have to be replaced by an institutionalised system of impersonal rights¹³ applying to all members of the elite; and, finally, these impersonal rights have to be gradually made available to wider social groups. Evident and significant advantages in terms of economic performance stemming from open access (North *et al.* 2009) will come to life only after these steps have been taken.

According to Acemoglu and Robinson (2012) there is also a synergy between inclusive economic and political institutions, and between extracting economic and political institutions. Despite their affinity, however, even structures with mixed types of institutions may remain stable for a limited time. The process of continuous transition shows exactly these types of features, with a growing number of inclusive institutions in the economy, but without the same transformation in politics. Acemoglu and Robinson (2012), however, argue that, in the longer term, these mixed systems cannot replicate the performance of those with a dominant position of inclusive economic and political institutions. Without democratisation, the authoritarian system emerging from the process of continuous transition (Authoritarian Capitalism in Figure 3) cannot compete with democratic market economies in the long term.

¹²Kornai (2000) refers to another variant as well, where communist dictatorship is replaced by an anti-communist one. This type will not be discussed here.

¹³But only if this step is desirable for the privileged.

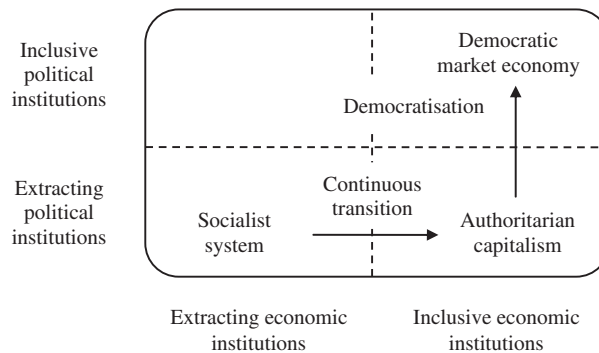


FIGURE 3. CONNECTIONS BETWEEN THE DIFFERENT TYPES OF INSTITUTIONS

Taking China as an example, this article will show that, in a system resulting from the process of continuous transition, it is not possible to build up a full set of inclusive economic institutions existing in democratic market economies (including a sound financial system, performance-based competition between economic players or well-functioning factor markets), since economic rents (resulting from extracting economic institutions) are vital for the elite to maintain its monopoly of power. Therefore, economic transformation can only be partial, with serious efficiency and incentive problems. Thus, the system of authoritarian capitalism is a hybrid one, where political institutions are predominantly extracting, and alongside inclusive economic institutions there are numerous extracting institutions as well. Considering these characteristics, we may conclude that true economic transition can only take place in conjunction with reform of the political system.

The logic of the Chinese reform process

Phase one: from socialism to reform socialism

There are several interpretations of the Chinese reform process. However, most authors agree that it can be divided into two distinct periods: 1978–1993 and ongoing since 1993. The first phase of the reforms started in 1978, after the reformers led by Deng Xiaoping had won the struggle over succession following Mao Zedong's death, and went on until about 1993 (Naughton 2007, p. 90). The new approach of the second phase began to emerge after Deng's tour of Southern China in the spring of 1992, which gave a new impetus to reforms following the post-Tiananmen interlude of 1989–1992. Initially, for Deng, the reforms were predominantly the most important tool in the fight for the control of the party. The macroeconomic crisis after the Cultural Revolution created possibilities for him to defeat the hardliners: the heavy industrialists, and the oil faction (Shirk 1993, pp. 35–6). The succession struggle and economic problems combined to create a situation where a reform-oriented policy, which was markedly different from the previous one, promised huge political gains. Party leaders started to believe that reforms might contribute to reducing tensions, while maintaining the *status quo* might further promote dissatisfaction.

During the first phase of the reforms, reformers had to meet two parallel requirements. On the one hand, the results of reform had to be substantial enough to weaken the resistance of

party conservatives; but, on the other hand, they could not be too radical either, so as not to endanger the power of the Communist Party. Reformers therefore had to meet the preselection criterion. All three important areas of the first phase of the reforms—the introduction of the Household Responsibility System (HRS) in 1978–1979; the evolution and spread of Township and Village Enterprises (TVEs) since the early 1980s; and external opening through the creation of the first Special Economic Zones (SEZs) in 1980—were in full accordance with these requirements.

The greatest controversy within the party elite was generated by the rapid spread of the HRS, because it basically abolished collective farming and allowed households to make profits. Moreover, the HRS evolved out of local experiments to increase grain production without the sanction of the central leadership. Only after this brought about a remarkable upturn in agricultural output was the resistance of the party conservatives broken, leading to the official acknowledgement of this reform. The TVEs, which produced goods previously missing from the market with the help of cheap labour, also began to spread spontaneously. They were much more responsive to costs and prices than state enterprises, and were massively subsidised by local and provincial governments (Naughton 2007, pp. 277–78). TVEs soon became the most prominent vehicles of economic development not only in the countryside, but across the whole country.¹⁴ The third reform, the creation of SEZs, opened the way for foreign investors without the need to change the structure of the SOEs. Because these reforms did not affect the fundamentals of the socialist system, their introduction was acceptable to the communists. For Deng, they provided obvious political gain, since they strengthened the position of the reformists within the party.

The next steps in the first phase of the reform process were the introduction of the ‘dual track system’, the dual price system, and the subsequent fixing of plans in absolute terms in 1984. All these steps meant only partial transformation of the coordination mechanisms, in such a way that did not endanger the fundamental institutions of the classical system. By the mid-1980s, these reforms resulted in significant changes in the functioning of the Chinese system, which from this point on can be called ‘reform socialism’. Initial reforms met the preselection criterion, and their implementation provided strategic advantages to the reformers while also changing the distribution pattern of rents. The increase of incomes resulting from the reforms was especially high in rural areas. These huge incomes emerging from agriculture, the TVEs, and joint (state and foreign) ventures ultimately enriched local and provincial elites. In the first phase of the reforms, these groups became the main ‘winners’ and the most important base of the reformers inside the CCP (Shirk 1993, pp. 14–6). Among the relative losers were, however, the SOEs: besides their heavy social burden,¹⁵ they had to face increasingly serious competition from TVEs and hardening budget constraints.¹⁶

¹⁴From the beginning of the reforms until the mid-1990s, employment in TVEs rose from 28 to 135 million, while their share of GDP rose from 6% to 26% (Naughton 2007, p. 274). In addition, by the millennium nearly half of all Chinese exports were produced by these enterprises (Fu & Balasubramanyam 2005, p. 617).

¹⁵SOEs were responsible for providing free health care, education, pensions, and other benefits for their workers.

¹⁶There were very few losers in phase one, hence the slogan: ‘reform without losers’ introduced by Lau *et al.* (2000).

Despite remarkable results in terms of economic growth and efficiency, numerous problems emerged in the first phase of the reforms as well. First, parallel to rapid economic growth, inflation accelerated heavily (approaching 20% both in 1988 and 1989). Second, due to a deterioration in the financial position of SOEs, central budgetary revenues decreased significantly.¹⁷ Third, formulating macroeconomic policies which could have managed the market sector and the planned economy simultaneously proved extremely difficult. Finally, corruption had become commonplace (Wu 2005, pp. 73–4). The weakening position of the SOEs and the rapidly increasing significance and profits of the TVEs pushed control over financial resources to lower levels. The decentralisation of the distribution of rents occurred along with the creation of a clientele system. In time, however, the resources in the hands of central government had begun to dry up, leading to an inevitable weakening of the centre. By the end of the first phase of the reforms, therefore, the central leadership had only limited resources and limited room to manoeuvre; its power had significantly weakened (Naughton 2008, p. 110).

The reform process was accompanied by attacks from party conservatives. Sceptics considered institutional reforms as a betrayal of socialist principles, and their efforts to hinder further changes gave the process a ‘two steps forward, one step back’ character (Naughton 2007, p. 97). Various problems, such as corruption, rising inflation, and an increasing desire for democratisation brought people (predominantly students) onto the streets of Beijing, and several other bigger cities.¹⁸ Party leaders were divided regarding how to respond to the protests; in the end, however, they decided to suppress them using the military. The events in Tiananmen Square, where the military killed hundreds of demonstrators in June 1989, met with shock both at home and abroad, and the trust that the country had built thanks to the reforms was set back for years. Thus, despite its significant economic successes, the first phase of the Chinese reform process almost led to the fall of the Communist Party, which was avoided only with the help of the loyal army (Shirk 2007).

Phase two: from reform socialism to capitalism Chinese-style

The position of the party leadership became difficult after the events at Tiananmen Square. To meet the preselection criterion, they had to be very careful in planning further reform steps. Giving up the whole process was not a viable option, mainly due to the power of reformers inside the party who did not want to give up the increased revenues acquired as a result of the reforms. Applying the preselection criterion, therefore, required the party to ease tension by continuing reforms, stopping corruption, and achieving economic results. After Deng’s southern tour in 1992, a new phase of reforms was initiated by Jiang Zemin, this time backed by the industrial faction instead of the provincial one.

Besides macroeconomic stabilisation, reform of the SOEs, the bank sector, and the financial system has also begun. As part of a strategy of ‘grasping the large, letting go of the small’¹⁹ the party leadership has kept the strategically important big SOEs, while either (partially or

¹⁷While revenues in the beginning of the reform process amounted to one third of the GDP, by 1994 they decreased to 10% (Naughton 2007, p. 431).

¹⁸In May 1989, there were mass demonstrations, among others, in Canton (with more than half a million people), Hong Kong, and in the largest cities in Manchuria (Meisner 1996, p. 438).

¹⁹*Zhua da fang xiao* (抓大放小).

fully) privatising the smaller ones, transferring them over to employee ownership, or letting them go bankrupt. During the process between 1993 and 2003, nearly 50 million employees were dismissed, almost 40% of the SOE workforce (McGregor 2012, p. 16). In accordance with the specifications of the Company Law,²⁰ the majority of SOEs underwent a formal transformation; however, state influence and control remained vital (Guo 2003; Zheng & Chen 2009). Moreover, based on strategic considerations and following the successful examples of Japan and South Korea, the party leadership decided to revitalise and subsidise SOEs, and make some into national flagship companies (Huang 2008; Naughton 2008; McGregor 2012). The new slogan of ‘the state advances, the private sector retreats’ (*Guo jin min tui*) was the direct opposite of the policies the PRC followed in the first phase of the reforms.

The main form of financing of the SOEs has also changed in this phase of reforms. The former practice of direct state (ministry) financing gave way to financing by banks, especially the four big state banks that had seceded from the People’s Bank of China (the former Central Bank).²¹ The state-owned banking sector had always been the party’s most important tool for providing funds and credit. In the first phase of the reforms, the loans had mainly been intended to advance local growth (for instance through preferential loans to TVEs); from the mid-1990s, and especially after the bank centralisation of 1998, however, the main priority became SOE financing (Huang 2008). Credit has, therefore, been abundantly available for SOEs, while opportunities for private enterprises have shrunk significantly (Redding & Witt 2014b). This new policy thus has left small and medium-sized enterprises facing difficulties in accessing bank loans. Hong (2014, p. 176) illustrates this situation by the fact that while the national interest rate stood at around 5.4% in 2010, China Petrochemical Corporation and China National Offshore Oil Corporation had access to funds at 2.7% and 3.4%, respectively. Finally, the reform of the external sector also continued with a depreciation of the yuan, and it concluded with the convertibility of the current account and China’s accession to the WTO in 2001.

As a result of these reforms, foreign capital began to pour into the country at an unprecedented pace. FDI inflows accelerated from the mid-1990s, and by the end of the 2000s surpassed US\$100 billion a year.²² The biggest investor has been Hong Kong²³ but foreign tax havens have also been important sources of FDI due to the practice of ‘round-tripping capital’.²⁴ Despite the dynamic growth of FDI (including round-tripping capital), the

²⁰The Company Law of the People’s Republic of China came into force in 1 July 1994, and regulated the activities of all business entities (Huo 1995, pp. 373–89).

²¹The Agricultural Bank of China (ABC), The Bank of China (BOC), The Industrial and Commercial Bank of China (ICBC), and the China Construction Bank (CCB).

²²FDI inflows in 2013 were US\$124 billion (See, ‘Country Fact Sheet, China’, United Nations Conference on Trade and Development, available at: http://unctad.org/sections/dite_dir/docs/wir2014/wir14_fs_cn_en.pdf, accessed 23 November 2017).

²³With two thirds of all FDI inflows in 2013 (See, ‘Statistics of FDI in China in January–December 2013’, Ministry of Commerce, People’s Republic of China, available at: <http://english.mofcom.gov.cn/article/statistic/foreigninvestment/201402/20140200498911.shtml>, accessed 23 November 2017).

²⁴‘Round tripping capital’ refers to the fact that since privately owned mainland companies meet much less favourable conditions than foreign ones, they tend to send their money to tax havens and re-enter China as foreign companies. The World Bank (2002, p. 41) puts it at 25% of all FDI, while the lowest estimation of Xiao (2004) stands at 29.2, the medium at 40, and the highest at 50.8%.

role of foreign capital in investments had become marginal by the end of the 2000s,²⁵ thanks to an unprecedented growth of domestic investment, approaching half of GDP by 2013.²⁶ This points to the fact that the financing of China's rapid growth rests upon huge—mainly public—investment projects.

After the Chinese economy had been stabilised and inflation had been reduced in the mid-1990s, the weight of the public sector in the economy began to gradually decrease.²⁷ To assess this reduction, instead of using official statistics, it is worth looking at estimations that take account of state control and therefore provide a more realistic picture. According to OECD studies (OECD 2010, p. 106; 2013, pp. 39–40), enterprises controlled by the state (both directly and indirectly) produced 54% of value added in 1998, 41% in 2003, 31% in 2007, and less than 30% in 2012. During this period, the share of the SOEs in employment fell from 62% to 20%, while their share in all enterprise assets decreased from 73% to 51%. Other studies give higher estimates for the value added by SOEs as a percentage of GDP; for example, McGregor (2012, p. 4) puts the figure at between 40% and 50%, while Szamosszegi and Kyle (2011, p. 1) place it at 50%. The use of market prices in economic transactions was spreading rapidly, while direct price control was observable only in the energy and water sectors, and in a very small proportion of retail goods (OECD 2013, p. 39). Modern competition policy has been introduced, and an Antimonopoly Law entered into force in 2008 (OECD 2010, p. 121). The leaders of the CCP gradually recognised the fundamental institutions of capitalism: the establishment of a market economy became an official policy first tacitly, then explicitly, while the right to private property was constitutionally guaranteed in 2004.

Since the transition from socialism to capitalism has been interpreted as a series of successive reforms (see Figure 3), it is difficult to draw a clear line between the two systems. It is not surprising either that some scholars (Redding & Witt 2007; Tsai 2007; Huang 2008; Szamosszegi & Kyle 2011; McGregor 2012) have regarded China as a capitalist country, while others (Chu 2010; Fan *et al.* 2011) consider the current system a fundamentally socialist (although a market socialist) one. However, with regard to types of ownership and coordination mechanisms, China has significantly distanced itself from the planned economy model. Taking the previously described quantitative and qualitative changes into account, it can be stated that the change of system, in the sense outlined by Kornai (2000) has occurred, and that China has

²⁵It was exactly 2.9% (See, 'Country Fact Sheet, China', United Nations Conference on Trade and Development, available at: http://unctad.org/sections/dite_dir/docs/wir2014/wir14_fs_cn_en.pdf, accessed 23 November 2017).

²⁶45.5% (See, The World Bank, DataBank, World Development Indicators, available at: <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>, accessed 31 January 2018).

²⁷The distinction between, and the measurement of, the private and the state sector in China is particularly controversial. In official statistics besides SOEs and private enterprises there are numerous other categories, which include all other (partly state and partly private) entities. According to official statistics, in 2012 the share of SOEs in industrial output was 8%, while that of private enterprises was 30% (See, *China Statistical Yearbook* (Beijing, National Bureau of Statistics of China, 2013, Table 14-1), available at: <http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm>, accessed 30 January 2018). The state/non-state distinction is often used as well. However, this is misleading because it severely underestimates the share of the state sector, because it treats as 'non-state' players that are partly or indirectly owned or controlled by the state (Szamosszegi & Kyle 2011).

been transformed into a capitalist economy.²⁸ The change of system, however, only means that China has crossed the dotted halfway line in Figure 3, but says nothing about how far it has moved. The abovementioned authors, who have different views about China's current system, usually agree that the full development of a real market economy is still far away, and they also agree upon the most important areas where further reforms would be crucial to accomplish the transformation process: the financial system, the SOEs, and various local anomalies, including land ownership. As I will show, none of these areas are the intended target of reform. In the next section, I will argue that without political reforms—that is, without democratisation—transition cannot truly be accomplished, and the reform process will come to a halt. Consequently, instead of a Western-style market economy, China is likely to exhibit a hybrid form, in which mechanisms inherent to the socialist system can be observed alongside market elements. The incompleteness of the continuous transformation is not a specific characteristic of the Chinese case but a necessary systemic consequence.

Rents, the halt of the reform process, and the incompleteness of the transition

Just as in every authoritarian system, the elite in China limits access to valuable resources. In order to maintain its rule, preserve the stability of the leading coalition, and build a social base and clientele, the elite makes use of rents. Large-scale rent extraction from the economy is so evident in China that some scholars define the system as 'bureaucratic entrepreneurialism' (Lu & Gore 1999), 'state entrepreneurialism' (Duckett 1998), or 'bureaucratic capitalism' (Meisner 1996). This last term 'refers to the use of political power and official influence for private pecuniary gain through capitalist or quasi-capitalist methods of economic activity' (Meisner 1996, p. 300). Because of this fundamental feature of the system, Ho (2013, p. 813) uses the expression 'rent capitalism'. Rent-extracting practices at local, provincial, and national levels have clearly been products of the unfinished transformation process. The reform has served to intensify such practices by opening up new opportunities and creating a dense network of party and state bureaucrats who have been very much interested in keeping the emerging new system intact. Since these practices have been very profitable, and could be used to consolidate and increase political power, the players who reap the benefits have been extremely reluctant to implement further reforms that might threaten their privileged positions.

The most important vehicle for generating monetary rents in China has been the management of access to credit, public purchase orders, and public subsidies or tax-exemptions.²⁹ There have been also other specific forms of organisational rent extraction. Revenues without clear legal mandates, including illicitly levied fines, fees, and apportionments have often been used

²⁸This is the case even if, according to Fan *et al.* (2011, p. 1), '[A] host of its formal reforms emulate the institutional forms of a market economy, often in painstaking detail. But its heart remains resolutely socialist: strategically placed SOEs, SOE-controlled pyramidal business groups, and ubiquitous Party cells, Party Secretaries, and Party Committees leave Lenin's "commanding heights" firmly and exclusively under the control of the Chinese Communist Party (CCP), and consign much of the rest to provincial and local Party cadres'. Because their main aim is not to categorise the Chinese system but to answer the questions of, first, whether reforms will continue, and second, if it is possible that a true market economy can emerge under the surveillance of the party, this quote only strengthens our arguments.

²⁹On credit, Fan comments, 'in summary, China's tycoons, its barons of big business, are predominantly career bureaucrats and ex-bureaucrats: cadres the CCP Organization Department promoted through top positions in large SOEs and SOE subsidiaries. China's banking system appears well suited to channelling capital to these cadre-tycoons. China's entrepreneurs, who appear most often in the hybrid sector, rely largely on savings, somewhat on trade credit, and seemingly very little on the financial system' (Fan *et al.* 2011, p. 11).

excessively and irregularly, or retained illegitimately. Local and provincial governments have frequently used regulatory power arbitrarily, and in a predatory manner, as in the case of road tolls and charges. Finally, unreported and underreported funds, or the ‘small coffers’,³⁰ have been well-known tools for governments and government officials to increase their rents (Lu 2000).

Since the millennium, another new type of rent has emerged, designed to replace diminishing provincial and local revenues. The practice of selling land and housing has amounted to 25–50% of all provincial and local government revenues (Yeh *et al.* 2011, p. 17), and sometimes even more, nearly three quarters (Yuen 2014, p. 63). The increasing need for further urban space in the expanding cities has made the expropriation and selling of agricultural land a very lucrative business for local governments. The rent comes from the difference between the compensation the government pays to the peasants, and the real market value the government gets for the land from real estate developers. To stop this practice, the central government has taken several steps, among them a law that allows for land expropriation only if the reduction of agricultural land is compensated for by the simultaneous creation of an equal amount of agricultural land (Deng 2013, p. 193). Local governments, however, have found a way to get around this law by transforming rural residential areas into arable land, and building multi-storey houses for rural residents in less valuable areas on tiny plots. The resulting free quotas—the increase of net agricultural land—can then be sold by exchanging interregional land use rights, or used to transform other, much more valuable, rural land to urban use, reaping huge profits from sales (Deng 2013, pp. 192–94).

The practice of linking and exchanging urban and rural land parcels has created numerous problems. Although the villages demolished had usually been abandoned already because the dwellers had moved to towns, the exchange of land use rights has severely restricted the property rights of rural inhabitants. The problem has not only been that moving to an urban environment has made farming impossible, but the rights they previously had had in connection to their housing have ceased to exist in relation to their new homes (Deng 2013, p. 199). Often the violent nature of land appropriations³¹ has given rise to further difficulties, and severe discontent, which has been aggravated by the spread of land abuses and corruption. Thus, problems concerning rural land use, the protection of property rights, and the creation of land markets based on supply and demand are yet to be resolved. This is hardly surprising, given that maintaining the power and stability of the elite requires that all significant groups of the party, including local and provincial leaders, have their share of rents.

Party leaders have always been able to implement policies and define winners and losers. The state-controlled banking system helped TVEs until the mid-1990s; thereafter, however, resources have been channelled to the big SOEs. The change in the direction of the resource flows can be characterised by the distribution of Gross Fixed Investments. Despite the initially low weight of the private sector in the economy, 21.4% of all investments were realised here

³⁰“‘Small coffers’ (*xiaojinku*) are secret funds kept by government agencies, state enterprises, or other public units. These funds are not reported and their usage is kept unknown to higher authorities. Common methods used to create and maintain such coffers include concealing receipt records, impounding portions of profits or appropriations, and retaining cash income’ (Lu 2000, p. 279).

³¹Sargeson (2013, p. 1063) writes that ‘between 2010 and 2012 open source media reported that in at least 17 provinces conflicts over land expropriation resulted in people being shot, beaten and crushed to death, five cases of self-immolation (two involving three people), three bombings, thousands requiring medical treatment and unknown numbers being detained’.

in the 1980s, 13.3% between 1993 and 2001, and only 14.7% between 2002 and 2005. More interestingly, the share of the rural private sector decreased from 19.2 to a mere 5.5% during this period (Huang 2008, p. 21). In the 2000s, the share of the private sector in investments began to rise again, reaching 19.7% in 2007, and 24.3% in 2012;³² however, this is not high compared to the sector's weight in the economy.

The central preference for the urban state sector has been signalled by other subsidies as well, such as free land use or preferential prices for resources and energy (McGregor 2012, p. 24). According to Hong (2014, p. 178), actual industrial land rental fees that the SOEs should have paid between 2001 and 2009 amount to almost 4,000 billion yuan (or two thirds of their total nominal profits). Non-monetary rents have also been very significant. The availability of relevant information, political connections, relationship networks, and the well-designed and centrally controlled cadre system with its distribution and redistribution mechanisms of privileges have fundamentally defined the functioning of the whole system (Fan *et al.* 2011). In general, the problem of rents is especially important in the process of continuous transition because, as reforms go on, there are fewer and fewer suitable means remaining for the elite to create rents. Therefore, one of the most important keys to continuous transition is the continuing ability of the elites to generate rents.

Clearly, these pressures forced the party leadership to initiate fiscal centralisation in 1994, and to develop strategically important SOEs.³³ Figure 4 illustrates that as a result of the strategy of 'grasping the large and letting go of the small', and a cutback in social expenditures (in the case of SOEs), the profits of SOEs between 1999 and 2012 rose 15-fold (an average of 20% per year), their number decreased from 61,000 to 18,000, while their profits-to-assets ratio rose from 7% to 13% during the same period.³⁴ The profitability of SOEs, however, stems from their privileged positions and the huge state subsidies, not from their high overall productivity and efficiency.³⁵ A smaller group of large SOEs, which are run by central authorities (centrally administrated state-owned enterprises—CSOEs), reap particularly large benefits from the restricted competition. CSOEs made total profits of up to 1,300 billion yuan in 2012 (more than 80% of all SOE profits) compared to a figure of 240.6 billion yuan in 2002, showing an average growth rate of 18.4% between 2002 and 2012. The dominant position of CSOEs in some industries is striking. In the telecommunications sector, for example, the three largest CSOEs accounted for 95% of all revenues, while in power generation, seven of them generated almost 70%. Finally, while in 2003 there were only six CSOEs listed in the Fortune Global 500, in 2012, there were 54 (Hong 2014, pp. 166–68).

The strengthening of the largest SOEs, especially CSOEs, is hardly incidental. Party-state leaders have always treated these enterprises as the party's main tool of policy implementation,

³²*China Statistical Yearbook* (Beijing, National Bureau of Statistics of China, 2013, Table 5-3), available at: <http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm>, accessed 30 January 2018.

³³China's 'national team' of large industrial firms included: Aviation Industries of China (AVIC) in the aerospace industry; Sinopec and CNPC in oil and petrochemicals; Sanjiu, Dongbei, and Shandong Xinhua in pharmaceuticals; Harbin, Shanghai, and Dongfang in power equipment; Yiqi, Erqi, and Shanghai in automobiles; Shougang, Angang, and Baogang in steel; and Datong, Yanzhou, and Shenhua in coal mining (Nolan 2004, p. 234).

³⁴See, *China Statistical Yearbook* (Beijing, National Bureau of Statistics of China, 2013), available at: <http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm>, accessed 30 January 2018.

³⁵In addition SOEs were also entitled to retain almost all of their profits, which, by the mid-2000s, amounted to more than 3% of the GDP. In 2009 6%, in 2010 only 2.2% of profits of the SOEs were withheld by the state budget (McGregor 2012, p. 24).

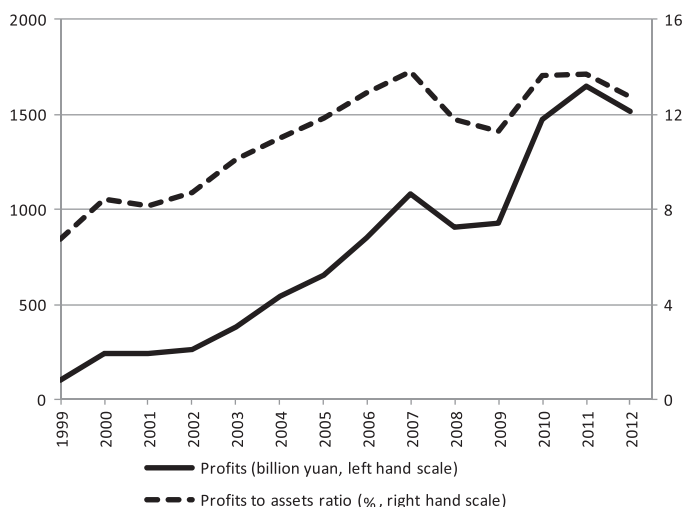


FIGURE 4. PROFITABILITY OF SOES IN CHINA BETWEEN 1999 AND 2012

Note: For statistical purposes here, SOEs are defined as enterprises with yearly revenues of more than 500 million yuan (between 1999 and 2005), more than five billion (between 2006 and 2011), and more than 20 billion yuan (after 2011). Thus, the number of SOEs included in this statistic has been gradually reduced. ‘Profits to assets ratio’ means the percentage share of the sum of profits, taxes, and interests relative to the average stock of assets.

Source: *China Statistical Yearbook* (Beijing, National Bureau of Statistics of China, 2013), available at: <http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm>, accessed 30 January 2018.

and, perhaps even more importantly, as a source of rents, and have tried to create a favourable environment for them, including subsidies, market access, bank loans, tax rates, and land-use rights (Hong 2014, p. 167). What is more, the elite consider these huge profit-making enterprises as personal interests, and, increasingly, try to transform them into powerful family conglomerates controlled by their offspring and protégés, who may use their privileged positions to build up their own political career (Ho 2013, p. 826).³⁶ The evidence is abundant that political and economic power are strongly interconnected in China, and the increasing resources—rents—coming from these large SOEs play an integral role in sustaining the current system. Consequently, since the party elite has a strong interest in maintaining and strengthening large SOEs, further reforms aimed at making these industries more competitive are highly improbable.

The persistence of rent-creating processes has severe consequences for the continuation of the reform process and the future completion of the market economy. The most important sources of rent extraction created by the party elite during the reforms are based in areas, which by now, should logically be the main targets of future reforms. The transformation of monopolised SOEs, the state-controlled banking system, and local land-markets are all among the most urgent tasks, without which the transition cannot be completed. However, if the party

³⁶Ho (2013, pp. 815–20) lists some examples: Kong Dan, son of Kong Yuan, former minister of the Investigation Department, and Xu Ming, former Secretary General of the State Council, is currently the CEO of CITIC, one of the largest Chinese state-owned investment companies; Jiang Mianheng, son of Jiang Zemin, labelled ‘Shanghai’s King of IT’, holds a 12% ownership share in China Netcom; Li Xiaopeng, ‘King of Asian Power’, son of Li Peng, the former premier, is currently Minister of Transport. Previously he was the chief executive of China Huaneng Group.

sanctioned these reforms, its economic control would be radically decreased; without its most important source of rents, its power would be largely diminished. Given the pervasive nature of organised rent extraction in China, and the importance of these sources to the privileged groups of decision-makers, one may conclude that this scenario is hardly conceivable: the party elite has a strong interest in maintaining the current system, which, as a consequence of the continuous application of the preselection criterion, ensures the monopoly of power of the Communist Party.

The shrinkage of the party state (Csanádi 2005) and the reduced number of tools available for shaping and influencing processes force the elite to refrain from introducing further reforms. Thus, since the room for manoeuvre of the party regarding introducing new reforms has gradually diminished, and the current institutional configuration is highly favourable for the elite, it seems increasingly probable that no further significant reform steps will be taken at all and that the reform process will come to a halt. This phenomenon has been recognised by several scholars. Pei (2006) referred to it as a ‘transition trap’, while in another paper he refers to ‘partial reform equilibrium’ (Pei 2007). Similar to Hellman (1998), he means ‘a state of affairs in which incomplete reforms have created conditions that motivate the ruling elites to maintain the *status quo* and resist further reforms, hence the trap’ (Pei 2007, p. 1). In this analysis, the socialist system in China has not been replaced by a developed (Western-type) capitalist one but by a hybrid system,³⁷ in which the undeniable dominance of capitalist institutions is accompanied by characteristics of the previous socialist system, alongside reform-related anomalies (such as corruption or rent seeking). In sum, the inconclusiveness of the transition can be traced back to system-specific causes.

Concluding remarks

What are the possible consequences of the stagnation of the reform process? First, the politically motivated lending practices of the state-owned banking system contribute to a severely distorted flow of funds, which may lead to the inefficient allocation of resources, to an increase of non-performing loans, and ultimately, to weaker economic performance and a slower growth rate. Second, despite their seemingly stellar performance, Chinese SOEs—in particular CSOEs—in privileged positions usually lack the motivation to become more competitive and innovative, while due to the soft budget constraint they face, their productivity and competitiveness severely lag behind enterprises operating in Western-type market economies. And third, excessive rent extraction and corruption at all levels of the economy lead to a waste of productive resources, which not only limits long-term development but also contributes to the persistence of some extracting economic institutions as described by Acemoglu and Robinson (2012). All of these features raise serious questions about China’s economic prospects as well as the sustainability of its political system.

Though the problem of democratisation lies beyond the scope of this article, it should be mentioned. It is evident from historical examples (South Korea or Taiwan) that authoritarian capitalism may be transformed to a more or less democratic one, though this process is far from inevitable. In the case of China, the conditions of democratisation depend on internal political forces, the direction and power of dominant intra-party strategies, the seriousness of

³⁷We may also refer to it as ‘authoritarian capitalism’, as in Redding and Witt (2014b) and McGregor (2012), or ‘capitalism Chinese-style’.

problems threatening the party leadership, and the ability of the party to adapt or resist. In the last decade, slow democratisation and a gradual institutionalisation of the Chinese political system regarding the rules of nomination and succession in the party leadership have been observable. There are many studies examining the effectiveness of the Chinese party cadre system, different forms of training new elites, and the system's ability to adapt. According to Chai and Song (2013, pp. 85–6) the experiment of introducing direct (seemingly democratic) elections in local politics in 1998 has only strengthened the party's capacity to keep the processes under control in the countryside, moreover, the decentralisation of power in the case of civil and local leaders has been occurring under the surveillance of the Communist Party. Although these processes are far from constituting genuine democratisation, the recognition of local opinions through the voting process may alleviate political tensions without the need to make real concessions (Mu & Zhang 2014). The ability of the party to adapt is thus very strong (Xie 2008); it is adept in fighting a variety of threats, and demonstrates resistance and resilience (Nathan 2003).


The growing number of demonstrations³⁸ shows, however, that the position of the party leadership is not without risk. Among the most significant causes of dissatisfaction are severe pollution, land appropriations, and labour disputes (Ong & Göbel 2014, pp. 194–96). Economic imbalances such as the unsustainably high investment rate or the large amount of public debt also threaten the stability of the political system. Many studies highlight that one of the factors that strengthens the Chinese political system is the country's high economic growth rate.³⁹ Once, however, the growth rate is significantly reduced, the CCP's monopoly of power may be shaken and political reforms may appear on the agenda. Woo (2012, p. 332), on the other hand, argues that the macroeconomic means through which the party leadership has maintained this pace are becoming less adequate; sustainable growth can be envisaged only if the whole political system is replaced and the rule of law introduced.

The increasing volume of state investments has led to huge local debts. Budget centralisation in 1994 cut local and provincial income, while burdens and expenditures increased heavily. To maintain the growth rate, local governments made large investments financed partly by selling land, and partly by loans from different sources. These were most often available outside the banking system, raising the so-called shadow banking system to an unprecedented level (Wong 2013). The scale of debt within this system reached 40% of the GDP by 2012 (Hu 2014, p. 56), while the ratio of all credits to GDP surpassed 200% (Wong 2013, p. 10). Although these numbers do not put China amongst the most vulnerable countries in the world, the high level of non-performing loans means that they do raise questions regarding the sustainability of the system. Borst (2014), Malmgren (2014), and Wong (2013) share the view that indebtedness has already reached a stage that threatens the Chinese financial system with rapid collapse, while others (Lo 2013; Hu 2014; Ross 2014) consider huge currency reserves and possible future incomes from infrastructural investments as insurance against such a disaster. However, the direction of these processes is very problematic, and—in line with arguments put forward by Acemoglu and Robinson (2012, p. 94), Huang (2013), and Woo (2012)—will not permit the high rate of current Chinese growth to continue in the long term.

³⁸The number of 'mass incidents' was 8,700 in 1993, 87,000 in 2005, and an estimate of 180,000 in 2010 (Ong & Göbel 2014, p. 178).

³⁹See, for example Huang (2013, p. 54), Shambaugh (2016, p. 21), Wu and Ma (2016, pp. 240–53).

Finally, it may be interesting to compare China's development path with those of other East Asian economies, namely South Korea and Taiwan. To assess the similarities and the differences, it is important to take into account the Communist Party's ability to adapt and resist, and the processes that threaten the party's monopoly of power, as highlighted in this article. If there were substantial changes in the position of the elite, or tensions escalated to an explosive situation, the leadership could conceivably lose control over events, leading to either a violent change of regime or a peaceful democratisation process. The latter alternative may follow the South Korean or Taiwanese example, during which the elite gradually provided access to valuable resources to wider groups of the society, laying the foundations of an 'open access order' (North *et al.* 2009). Taking into account China's size, its decentralised characteristics, and the huge regional differences, such a process would last longer than in South Korea or Taiwan, perhaps taking decades to reach a more democratic system. In the long run, however, this version seems to be the most probable outcome: the breakdown of the reform process, the loss of room for manoeuvre, and the increasing threats to the elite will sooner or later consume the reserves of the elite, absorb their rents, and make it impossible to artificially fuel rapid economic growth. At the same time, the party, given its power, the enormous volume of rents still available, and its deep social embeddedness, seems strong enough to maintain the *status quo*, avoid forced changes, and to operate this hybrid system of authoritarian capitalism with socialist elements for the foreseeable future.

ANDRÁS SZÉKELY-DOBY, Associate Professor, Department of Comparative and Institutional Economics, Corvinus University of Budapest, Fővám tér 8., 1093 Budapest, Hungary.
Email: andras.szekely-doby@uni-corvinus.hu.  <http://orcid.org/0000-0002-8696-1317>

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