# A Comparative Study of East Asian Capitalism

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NINE

# Multiple Institutional Templates for Corporate China

## *The Evolution of Industrial Networks during Marketization*

LOWELL DITTMER AND KUN-CHIN LIN

Though of course each modernizing nation-state is distinctive, the East Asian developmental experience, as Hong Yung Lee (2005) has pointed out, inherits a similar traditional cultural legacy and shares a number of broadly analogous socioeconomic patterns. These include a focus on the collective (variously defined) rather than the individual as the primary unit of accounting and identity, a high degree of pragmatic flexibility as to specific means combined with a disciplined and concerted focus on long-term developmental objectives, and high respect for authority and orthodox learning combined with considerable informality in its interpretation of particular problems (i.e., a situation ethics). Within this broad pattern there are distinctive national experiences, such as the Chinese moralistic suppression of informal groups as "factions" vs. the much greater Japanese (and Taiwanese) tolerance for factional politicking, the mainly kinship-based Chinese definition of the primary unit vs. the South Korean (hereafter "Korean") territory-based definition or the Japanese function-based definition; the greater Chinese tolerance for collegial authority and familial fissiparousness vs. the Japanese emphasis on primogeniture and patrilineality vs. the Korean intermediate position.

This chapter attempts to analyze the People's Republic of China (PRC) pattern or "institutional template" of political-economic-cultural development during the period of "reform and opening to the outside world" since the Third Plenum of the Eleventh Party Congress in December 1978, during which China quadrupled its Gross Domestic Product and in three decades became one of the world's leading economic powers. Although

there is a growing literature on Chinese industrial reform (written largely by academic economists), the theoretical analysis of the causal dynamics of political-economic-cultural change has been slower to progress. This contribution is but modest preliminary spadework in a field deserving more intensive cultivation.

Our purpose here is to explore, from a macroperspective, watershed changes in the evolution of the "institutional template" for state-owned enterprises (SOEs) in post-Mao China. This has been a period of great dynamism, not only in terms of secular GDP growth rates but also in the transformations of the political-economic structure in which this change has been embedded. We identify three distinct periods in the reform of the state-owned sector since 1978: a revived command economy (1978–1983), a dual-track reform economy (1984–1997), and a recentralized corporate economy since 1998. Each period displays a distinctive mix of authority, exchange, and network relational principles within the overall context of a political structure that has shifted gradually (and incompletely) from state ownership to corporate, from plan to regulation.

In the first period, the state attempted to revive the planned economy in relatively pristine form, purging the radical followers of the Gang of Four and rationalizing the plan in various ways (more play for material incentives, greater autonomy in enterprise accounting, etc.) to achieve greater efficiency. The traditional distributive emphasis on heavy industry was also adjusted to give greater emphasis to agriculture and light industry in order to absorb unemployed workers, satisfy consumer demand, and boost the export sector. During the second period, the state attempted to lift the burden of a deteriorating central planning system by giving greater fiscal autonomy to enterprise management and introducing a dual-track system to move to a market economy while concomitantly reducing the scope of the central plan. Though highly successful in terms of economic productivity, increasing economic autonomy created confusion over ownership roles and hence led to attenuated authority relations and a proliferation of informal forms of exchange, eventually making the phasing out of the planned economy mandatory for the state's fiscal survival. In the third period of corporate recentralization, the central government sought to create a bifurcated corporate landscape in which Beijing asserted effective regulatory control over the macroeconomy and reassumed de facto control of the key industrial enterprises (Lenin's "commanding heights"), while leaving the majority of industries to market forces. We suggest that the consistent objective behind the central state's manipulation of the institutional template during all three periods is its prioritization of the authority principle—within an administrative or corporate hierarchy—over the exchange principle throughout the process of marketization, in order

to assure macroeconomic stability and regime survival amid transitional uncertainty.

## The Evolving "Institutional Template" of Chinese Industrialization

We define an "institutional template" as consisting of three conceptually distinct principles: authority, exchange, and network relations. These principles have varied in their priority over time as the state has shifted from a regulatory to an ownership role. These two dimensions establish a 3×2 matrix that captures the organizational logic of the industrial economy in the course of reform (see table 9.1). The following sections will further refine the components of this schema and apply it to China's economic transition.

### *Principles of Economic Transactions and Roles of the State*

The Chinese state has played two roles in relation to the economy: first, it arbitrates economic relations from the "outside" as a regulator; and second, it engages directly in these relations as an enterprise owner. As a regulator, it sets the ground rules for price signals and competition. An "outsider" or third-party status does not necessarily mean that the state is disinterested, but simply that it exercises the prerogative to set the ground rules for and adjudication of conflicts between those involved in transactions. While relinquishing control over intraenterprise governance it asserts sovereign control over interenterprise transactions. As an owner, the state also makes strategic decisions regarding the structure of ownership and long-term goals of SOEs. The nature of ownership may vary even within given types of corporate governance and property rights regime, and ownership is not clearly correlated with performance—thus sole ownership does not necessarily imply better control or worse performance than majority shareholding of a corporation.

Authority relations follow the contour of the formal power structure and are implemented through administrative commands that are generally not subject to negotiation except through various channels for appeal internal to the administrative corporate hierarchy. Authority relations aim to mobilize local resources and control their use according to the needs of the superiors or principals, typically at the expense of the independent initiatives of local agents, in contrast to the structure of incentives under the exchange and network principles.

In the context of Chinese economic reform, authority relations permeate the command economy as the administrative hierarchy under party supervision put into effect the five-year plans. Direct ownership of a large proportion of productive forces not only reinforces the convergence of

Table 9.1. The Organizational Logic of the PRC's "Institutional Template"

| *Principle of Economic Relations* | *Role of the State* | |
|---|---|---|
| | *Regulation* | *Ownership* |
| Authority | *Tiaokuai* federalism | Corporate governance |
| Exchange | Rules of market exchange | Property rights |
| Network | Association or collusion | Interlocking directorates |

political and economic hierarchies but also reduces resources for resistance to fiats from above. While the regulatory role of the state remains undeveloped and largely irrelevant to the daily functioning of firms, it is not entirely absent under the planned economy. Due to bureaucratic fragmentation and overlapping jurisdictions of "line" ministries and local governments, firms as "agents" of multiple political "principals" typically find room for the manipulation of superior orders or get caught up in turf wars. In these circumstances, State Council agencies such as the State Planning Commission, or its current reincarnation as the National Development and Reform Commission (hereafter NDRC), step in to settle the conflicts. The central agencies also act in a regulatory capacity in allocating resources among the provinces and regulating interprovincial competition, with major consequences for economic growth during times of relatively decentralized governance between Beijing and the provinces. In its regulatory capacity, the state does not mainly rely on imposing its will on the contending parties, but rather attempts to persuade them to sacrifice self-interest on behalf of the national plan's developmental goals. Nevertheless, the likely outcome and process of adjudication follow the power structure rather than some abstract rule of exchange.

Exchange refers to the transaction of goods and services through competition between relatively autonomous economic agents. Sometimes described as "horizontal" in contrast with the command-based transactions within an administrative hierarchy, exchange is predicated on price signals that capture the opportunity cost of using the same resources in alternative ways. Exchange relations excel in offering incentives to autonomous agents who make the best use of private information. In an ideal-typical market context, efficient legal and market institutions create the "right price." In less ideal situations, commoditization imperfectly reflects the actual supply and demand of the market, or fails to internalize major welfare functions such as environmental externalities and social goods. It

is arguably more accurate to interpret cases of exchange based on "wrong prices" as decisions based on a mix of authority and free market principles. However, to insist on the ideal type would render us incapable of analyzing China's (or possibly any other) economic transition; therefore, we will take a broad view of the exchange principle to encompass economic transactions based on price signals formed through profit-motivated competition, even if actually conducted in the context of imperfect market institutions such as quasi-private ownership.[1]

The state's regulatory role in competitive exchange is relatively straightforward, as it involves establishing the rules of the game for market exchange. Its ownership function is more complicated. In a hybrid economy, SOEs engage in exchange with other economic entities via the intermediation of the competitive rules and pricing institutions established by the regulatory state. The tremendous potential for conflicts of interests and systematic favoritism can only be contained if the state makes a credible commitment to impartial management of its firms and reduction over time of its ownership shares. While moving toward this commitment, central reforms face the risks of fiscal disruption and attenuation of principal-agent relations with managers.

The network principle of exchange adheres neither to administrative nor competitive prices, but to interpersonal relations in which a nexus of trust is a necessary prerequisite, either for relatively short-term transactions (e.g., bribery, political quid pro quo) or longer-term kinship or quasi-familial relationships (connections, or *guanxi* in the Chinese context). These relationships are necessarily informal and quasi-private, occasionally even conspiratorial. Network relations thrive in a pool of inside information contributed by and disseminated among members. The preconditions for the emergence of a network principle are (a) an entrenched "organizational field" with a relatively stable set of actors; (b) repetitive games to establish information and communications patterns; and (c) persistent environmental conditions of threat or uncertainty to prevent the institutionalization of network relations into either authority or exchange principles.[2]

The works of Douglass North (1981, 1990) and the rich literature on East Asian developmental states (e.g., Moon and Prasadi 1994) suggest that informal networks develop as expedient intermediating responses to the coexistence of formal political hierarchy and arms-length market principles of economic exchange. Network structures entrenched within

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[1] On the relative importance of competition in market formation, see Killick and Commander (1988).

[2] See Granovetter (1985), Powell and DiMaggio (1991), and Uzzi (1996).

the socialist production hierarchy become rearranged in response to the state's use of its assets and the introduction of new working arrangements in the nonstate sector, as well as to new rules of exchange established by the regulatory state. Whether these adaptations lead to increasing support for market principles or the informal undermining of formal institutions in the course of transition is an important area of inquiry.

In the next section, we elaborate on variations in the principles of economic transaction, hierarchical authority, and interpersonal relations in the course of the shift from planning to regulation in order to delineate three periods of "institutional templates" in the Chinese SOE sector. First, let us situate SOEs in their broader economic and institutional context.

*Multiplicity of Institutional Templates*

As market reform gathered momentum through the 1990s, China's national economy became increasingly complex and differentiated, tending to confound rather than clarify our analysis of authority, exchange, and network relations. Firms have become embedded in a variety of organizational contexts, with various ownership, sectorial, and geopolitical characteristics. By the turn of the millennium, China's exit from socialism had eventuated in four patterns of industrial organization:[3]

1. A cutthroat jungle of locally and informally financed, mostly small-scale and labor-intensive, collective and private enterprises formerly known as "township and village enterprises" (TVEs), which approximate the pattern identified with overseas Chinese entrepreneurship in Southeast Asia, Hong Kong, and Taiwan. These firms confront a vigorously competitive market with low barriers to entry, exogenously determined prices, mobile labor market regimes, and relatively hard budget constraints stemming from limited credit availability. Due to an ambiguous ownership structure, hierarchical links to the local state are often retained, though it is hard to tell whether these are more than nominal. As competition heated up in the late 1990s, privatization ("ownership reform" in Chinese) became the way for local states to exit as stakeholders. Informal networks now tend to aggregate around family or work units, indicating a revival of traditional business cultures relying on family or common origin allegiances and trust mechanisms.[4]

[3] For representative research on the characterizations, see Keister (1998); Tsai (2002); Guthrie (2002); Wedeman (2003); Huang (2003); and Lin (2006).

[4] For general theories on firm networks in Asia, see Hamilton and Biggart (1988); Luo (1997); Peng (1997); Peng (2000); and Tsui-Auch (1999).

2. A rapidly expanding foreign-invested (often wholly foreign-owned) enterprise sector (FIE). The FIE sector is a vigorous hybrid, which mixes the labor-intensive sweatshops of the local TVEs and collective enterprises with the high-scale, capital- and technology-intensive characteristics of the domestic SOE sector. In both cases we find heavy reliance on market exchange, merciless personnel policies, and organizational flexibility.[5] Studies of foreign invested firms in China—typically small and ethnically Chinese—show broadly similar network structuration. However, we should refrain from generalizations, as larger and nonethnic Chinese FIEs show somewhat different dynamics, and the supposed cordial and mutually beneficial reciprocity among firms in the rapidly growing foreign-invested sector may quickly morph into a mechanism for concealing information and avoiding regulation when the economy takes a downturn.
3. A "virtual economy" (Gaddy and Ickes 1999) among the uncompetitive industries preoccupied with the fallout from phasing out the planned economy without a ready place in the emerging free market. In those sunsetting industries with no compelling fiscal or developmental value to the central state, one finds a wide range of adaptive behaviors producing innovative firms that take advantage of new market information (Bacchetta and Dellas 1997), as well as desperate firms that deploy networks to shield them from competition with more successful firms. The virtual economy emerged among weak firms in the sunset sector of the Chinese industrial economy during market transition, as enterprise directors fought to keep open factories that produce goods with little market prospects, typically by sacrificing the transparency of formal and legal-rational transactions in favor of informal strategies that draw upon personal networks to create the appearance of profitability and capacity expansion. The virtual economy preserves structures and relationships while consuming social resources; markets become fragmented, public finance demonetarized, and localized firms chronically reliant on central handouts.[6] Thus, since the early

[5] Gallagher (2002) shows how foreign-invested firms in coastal areas do not produce better labor regimes. For a contrarian view, drawing mostly from case studies of state-controlled joint ventures and foreign invested firms, see Huang (2003), who argues that foreign investments follow political incentives, thus reproducing the state's favoritism of regions, sectors, and producers.

[6] In Russia, the much-anticipated "market" essentially went "underground," taking on various forms of nonmonetarized, informal, untaxed, mafia-regulated exchanges (Woodruff 1999).

1990s central reformers such as Zhu Rongji have attempted repeatedly to rein in local managers' inclinations to engage in wasteful investment in capacity expansion, i.e., "duplicate construction" (*chongfu jianshe*), interenterprise arrears, i.e., "triangular debt" (*sanjiao zhai*), and asset-stripping through "diversification." These practices were hard to uproot in a downturn as firms could survive by drawing on resources from other players in the residual planned economy, including banks and backward- and forward-linked enterprises.

4. The rise of a group of about a hundred "commanding height" firms, mostly in capital- and technology-intensive production, i.e., the "strategic" or "pillar" industries, carefully nurtured by the state to compete with Korean, Japanese, and Western multinational corporations (MNCs) in the international market. The perennial trick for the central reformers is to segregate the commanding heights from the dolorous fate of the sunset industries. For the foreseeable future the commanding heights are likely to continue to be essentially state-managed—in the guise of the state as majority shareholder rather than exclusive owner as in the previous planned economy—and the prices and supply-demand ratios comprising their markets seem to some extent state-managed as well, including the supporting networks of industrial cartels or trade associations. Outward foreign direct investment by these firms—most clearly evinced in the shopping sprees of national oil corporations since 2003—also relies heavily on high-level diplomatic initiatives and the ready availability of credit in state-controlled financial institutions.

We focus exclusively on the governance of this last category of firms in the remainder of this chapter. Comparative historical experience suggests that the success or failure of the state to act as regulator of nascent market forces in direct competition with private and foreign economic actors will strongly influence the pattern of industrial and urban sociopolitical organization that ultimately emerges, helping to shape the institutional template that forms in a modernized China.

## The Evolving Institutional Template for Chinese Industries

### *Period I: Reviving the Command Economy*

Mao's designated successor Hua Guofeng and the heavy industry and energy ministerial advocates who supported him never intended to stray far from the Stalinist economic paradigm and the affirmative "lessons" of reform in Eastern Europe and China in the sixties. Thus they tried to

engineer an erasure of late Maoist imprints on the Chinese economy and a reconvergence toward the Soviet model (Naughton 1995, 64–65). Enterprises were drawn more tightly into the planning system through more precise material balance planning, strengthened central financial controls, and strictly enforced administrative prices. Hua's Ten-Year Plan attempted to achieve rapid growth by relying primarily on the expansion of the heavy industrial base, often by importing complete industrial plants, funded by an anticipated rise in foreign exchange earnings from petroleum exports. Alas, the oil revenues were not forthcoming and structural and macroeconomic imbalances quickly set in, forcing Chinese planners to scale back their targets (Naughton 1995, 67–74). Naughton (1995, 59–64) argues that the expiration of Hua's reform prompted the sudden decision—made at the Third Plenum of the Twelfth Central Committee by the consolidated leadership of survivors of the Cultural Revolution—to initiate a recasting of developmental strategy, even though the same leaders had long been grappling with chronic problems of such an approach during the Maoist era.[7]

Under the revived command economy approach, authority relations coordinated the units producing for the plan. At the central governmental level, the plan conflated formal ownership with regulation of state-owned assets. State-owned production did not depend on the observance of external price signals simply because the logic of planning was anathema to market forces. Instead, SOEs produced according to their position in a chain of administrative allocation deriving from industry-specific macroeconomic targets established by the Five-Year Plan. The chain of production contained several nodal points of relatively independent subcentral state agencies with divergent interests but overlapping jurisdictions. These nodes included the ministries (Bachman 1991), the provinces (Shirk 1993), the local cellular economy (Shue 1988; Donnithorne 1972), and the parallel hierarchies of the party-state (Lee 1991; Manion 1993); each nodal point was "embedded" in a unique array of socioeconomic and power relations. Price, where it existed, was negotiated to accommodate the various interests; in this sense, it was no different than other politically stipulated goals such as production targets for and welfare obligations of the enterprise. This institutional arrangement served the interests of the central planners in providing predictability and stability, yet allowed room for "particularistic contracting" to foster support and compliance from a wide range of interests (Shirk 1993).

[7] For a detailed analysis of incremental learning on the basis of fundamental continuity in the worldview of elite reformers from the first Five-Year Plan to the reform era, see Reardon (2002).

Enterprise managers had no incentive to observe price signals as the determinant of marginal production. Exchanges took place via administrative allocation, and, where nominal prices were visible, they were not specific to the transaction but typically constructed for accounting purposes, which in turn reflected the politics of the plan. Furthermore, the prices of inputs—investment capital, labor, and even raw or intermediate materials—were not internalized within the firm because "soft-budget constraints" (Kornai 1980, 1992) gave ample leeway for discrepancies between cost and return. Simply put, there was no consistent logic linking external prices to intrafirm pricing and production decisions. Even when an SOE geared up to produce for extraquota profitability, the microeconomics often failed to align properly—supply and demand for the product were rarely considered quantitatively with a clear notion of market boundaries and consumer base, and managers did not adjust wage and input costs to maximize profits.[8]

Circulation of goods and services within the national economy was highly circumscribed. The market remained tightly constrained and localized, though throughout the Cultural Revolution decade there was a fairly rampant gray market (*zou houmen*) for retail distribution of services, medicine, and other scarce consumer commodities. Except at the retail level, informal network connections were mobilized chiefly for ideological rather than economic objectives, such as the organization of criticism of the Gang of Four, or the mobilization of the summer 1978 *shi shi qiu shi* campaign in support of Deng Xiaoping's policy of reform and opening to the outside world. Bureaucracies at all levels teemed with personal networks designed to defend and if possible enhance the policy and power interests of their leading cadres. At the shop floor and commune levels, connections (*guanxi*) were officially structured in "neo-traditional" (Walder 1986) patterns, as managers and activists traded ideal and material payoffs for enthusiastic compliance and economic performance.

*Period II: Dual-Track Hybrid System (1984–1997)*

While SOEs started enjoying increased autonomy and profit-sharing schemes as early as the late 1970s, institutional reform did not take off until 1984 with the formalization of the financial obligations of SOEs in taxes, the rapid expansion of the nonstate sector, the commercialization of domestic banks, and the introduction of the "dual-track pricing" system

[8] One only needs to note the steady climb of wage levels and fixed-capital investment through the 1980s and early 1990s, unperturbed by several business cycles, to comprehend the disarticulation of various functions for capital, labor, and material inputs.

based on the coexistence of the plan and the market channels for allocating and pricing goods.[9] While the dual track perpetuated "soft-budget constraints" and associated problems of incomplete property rights, it provided output stability and ensured the attainment of the conservatives' key concern of controlling investment resources, while allowing state firms to begin transacting with and even operating as above-plan, market-opportunist firms (Rawski 1993, 33; Naughton 1995, 8). Naughton (1995, 243, 293) has christened this strategy "growing out of the plan," as the planner gradually reduces the scope of planning and allows the nonstate sector to grow beyond it through liberalization and price reform, eventually leveling the playing field between state and nonstate sectors.[10]

Authority relations were exercised through hierarchies undergoing ongoing decentralization. Firms selected for reform enjoyed expanded autonomy, and were permitted to retain a share of profits, practice accelerated depreciation, and exploit the right to sell above-plan output according to market prices determined by supply and demand; the managerial "contract responsibility system," since its widespread implementation in 1987, incrementally delegated to managers the authority to make purchasing decisions on nonstrategic goods, draw up production plans, set recruiting criteria, and restructure the firm.[11] From 1985 to 1988, profit retention emerged as the main vehicle for negotiating the financial obligations of enterprises, increasingly taking the form of long-term contracting, which resembled the leasing of state assets to managers (Shirk 1993, 280–330; Naughton 1995, 228, 285). Profit retention proved to be so popular that enterprises aggressively bargained with their often sympathetic bureaucratic superiors, resulting in the program's overimplementation; however, the fundamental dependency of the enterprises on the plan was not reduced (Naughton 1995; Shirk 1993; Fewsmith 1999). Putterman (1995, 1051) construed the devolution of these disaggregated rights "as the adjustment of an agency relationship, rather than a shifting of the locus of ownership," which preoccupied the advocates of privatization.

In the era of decentralization, local cadres—playing the dual roles of central agents and brokers of market transactions—systemically exploited the porous organizational boundaries of the dual-track system by transferring costs incurred in both their within-plan and above-plan

[9] See Lin, Cai, and Li (1996) for a succinct recapitulation of the early-1980s enterprise reform. For insights into the continual policy debate between the conservative and reformist positions within the CCP leadership, see Fewsmith (1994).

[10] However, even as of the late 1990s, strategic goods and key corporate decisions remained under political control. See Lu (1996).

[11] Naughton (1995, 205–207) and Lu (1996, 154–156). The system "while providing incentives for good performance failed to penalize bad performance" (Pannier 1996, 15).

exchanges to local state coffers.[12] Cadres, their kin, and friends also established their own "companies" to conduct for-profit business on the side, taking advantage of the permissive environment designed to promote the "corporatization" of SOEs and "tertiary businesses" starting in 1993.[13] Consequently, the central and local states' continuing presence as dominant producers created conditions that increasingly undermined the central ministries' attempts to strengthen fiscal and macroeconomic management.[14] The coexistence of the plan and the market generated coordination failures as state and nonstate actors engaged in informal exchange and networking activities that simultaneously circumvented the disciplines of both plan and market and the balance of horizontal and vertical authority relations—or *tiaokuai* (Schurmann 1968)—within the administrative hierarchy.[15] State managers and local officials and their families acquired a habit of arbitraging in the multitrack pricing system, resulting in the wild speculation and investment overheating waves of the late 1980s and the early 1990s.[16]

As a result, the national economy in the 1980s and early 1990s became increasingly fragmented and populated by variations of quasi-legal and outright illegal property rights arrangements held together by informal networks. Informal networking shifted from its venue in the political struggles for power or survival to a contest for economic gain, and from the central to the regional or local levels. Below the provincial level, Boisot and Child (1996) and Wedeman (2003) documented the rise of administrative "fiefdoms" or protectionist localities. Wank (2002), Duckett (1998), Pearson (1997), Tsai (2002), and Zweig (1995) have provided independent studies on informal business networks tying local state entrepreneurs, business group leaders, managerial personnel, and domestic private and

[12] For a systemic overview of the local state's relations to nascent markets, see Lin (2006) and Duckett (1998).

[13] A live debate in the China field revolves around the relationship between local state agents and economic growth: some have attributed the momentum for investment and production for export to "local state corporatism," in which cadres put to use their unique position to mobilize the resources of the community and seek opportunities in the national and international markets, while others perceive them as rent-seekers who jealously guard their prerogatives and convert their political capital into private gains. These polar stereotypes show two sides of the same coin of the moral hazard problem inherent in decentralization, from the perspective of the central state as the principal of reform policies. See Nee (2001, 1991); Oi (1995); Zweig (1993); and Walder (1995, 975).

[14] See Dittmer and Wu (1995); Huang (1996); Brandt and Zhu (2000); and Shih (2002) on the redistributive politics of the inflation-retrenchment cycles from the late 1980s to 1995.

[15] Wu (1997) debunks the myth of "growing out of the plan," administrative decentralization, and managerial autonomy as effective exit mechanisms out of socialism.

[16] For institutional analyses of the dual-track pricing system, see Gore (1998) and Qian (2000).

foreign investors into complex overlapping networks of exchange arranged to compensate for the deficiencies of formal institutions. Keister (1998) and Ding (2000) identified the emergence of formally and informally networked business groups since the late 1980s, and the proliferation of "amphibious" firm organizations, respectively, recalling Stark's observation of "recombinant property forms" in postsocialist Eastern Europe. All of these findings suggest the emergence of a realm of economic activities beyond the control of the central bureaucracy, which must be balanced against post-Tiananmen indications of an authoritarian state effectively reasserting control over local economic agents and securing their ultimate loyalties (Huang 1996; Yang 2002).[17]

*Period III: State-Building Marketization in the Commanding Heights (1998–Present)*

Since the Fifteenth Party Congress in 1997, Chinese reform has taken a decidedly neoauthoritarian orientation, a trend likely to be reinforced in the short run by China's success in complying with the terms of accession to the World Trade Organization, immunizing it from trade sanctions. In the chronology of market reform, the year 1997 must rank as high as 1978 or 1992 in terms of dramatic turning points in transcending the residual socialist plan, changing the basic organization of the market, and redefining government-business relations.[18] Due to a macroeconomic shift from an economy of chronic shortage to one of widespread surplus, and increased central discipline in the financial market and banking sector (after the 1994 reforms), the reformers were able to overcome the entrenched industrial and local state "redistributive coalitions" (Olson 1982) in support of continued decentralization.[19] Generally speaking, reform since 1997 has halted the proliferation of "recombinant property forms," including informal relationships between firms and banks, firms and local governments, and among firms, by reasserting central authority in certain sectors and firms and unleashing the market in others. These changes reflected

[17] In a similar spirit, the sociological market transition debate (Cao and Nee 2000) has dwelled on empirical questions of (1) a decline of the advantages of redistributing power and other forms of political capital relative to nonstate economic actors who possess market power; (2) higher returns to human capital than under a centrally planned economy; and (3) new opportunities centered on market activities.

[18] Similarly important was the administrative streamlining of 1998 that eliminated several "line ministries" and further empowered generalist and macroeconomic-oriented ministries. Systematic research has yet to be conducted on the impact of bureaucratic reform on economic governance of the commanding heights, although several sectoral snapshots have suggested the improvement of the state's regulatory functions. See Pearson (2005) for an overall interpretation.

[19] For details on the political economy of 1997, see Lin (2003), especially chaps. 2 and 4.

a crucial convergence of the central state's capacity-building and market expansion.[20] Recentralization does not necessarily imply reversing the declining share of the state sector in the national economy, a trend established in earlier periods that would continue (see table 9.2). Rather, the state shifts from planning to regulation, relying more on competition to regulate the market economy, in the process gaining regime stability, revenue, and even legitimacy.[21]

The central state, reacting to persistent erosions of its ownership functions during earlier periods, withdrew its blanket support from the state sector, implementing a mixed strategy of de facto privatization in most sectors that was of little consequence to state developmental objectives and creation of centralized corporate hierarchies in the strategic sectors.[22] This strategy reached its zenith under the implementation of Zhu Rongji's "grasping the big, dropping the small" campaign bifurcating the state-owned sector.[23] Concurrently, the central state has strengthened regulation over pricing and competition in industries, and has reformed governance of commercial banks and rules of financial markets toward convergence with global best practices. The rapid expansion of domestic stock markets and the eagerness of foreign capital for Chinese assets have created a new channel for the state to gradually reduce its ownership, while earning returns in dividends and buying time for its experiments in corporate governance. Broadly speaking, the direction of post-1997 reforms has been toward a recentralization of economic power in the hands of Beijing as it strengthens its regulatory role over the market, even as it prepares to withdraw direct ownership and support from the vast majority of industries.[24]

[20] For seminal views on state-building and marketization, see Polanyi (1944); Huntington (1968); Gold (1985); Evans, Skocpol, and Rueschemeyer (1985); Doner (1992); Chaudhry (1992); Haggard and Kaufman (1995); and Fligstein (1996a.

[21] For two recent treatises on the notion of a regulatory state in China, see Yang (2005) and Pearson (2005).

[22] For analyses of preferential treatment of the "strategic sectors," see Jin (2002); Liu (2001); Yin and Zang (2001, 1999); State Economic and Trade Commission (SETC) *Qiye gaige si* (2001); and Liang (2000). Also see SETC (2001) for a selective collection of relevant speeches of and discussions among elite policymakers.

[23] For a detailed analysis of Zhu's policies between 1998 and 2000, see Zweig (2001).

[24] The number of state-owned or state-controlled enterprises as percent of the total number of enterprises dropped from 26 to 21 during the 1998–2002 period, while the total registered capital of these enterprises declined from 56% to 54% of the total during the same period. State-owned industrial gross output as percent of the total from 1999 to 2002 plunged from 31 to 16, while shareholding and limited liability companies rose from 18% to 32%. SOE numbers declined (to around 114,000 in 2010, some 100 of them centrally controlled national champions), and their share of employment dropped. But since the 2008 global financial crisis, the SOE share of investment has risen, particularly in property, communications, and finance. In 2004 the average industrial output of SOEs was six times that of the average

Table 9.2. Period One: Revived Command Economy, 1978–1983

| *Role of the state and Principle of economic relations* | *Regulation (of side markets in agriculture and light industry goods, and import-export)* | *Ownership* |
|---|---|---|
| Authority: Command but not "commandist" | Formal: functional and line ministries<br>Informal: factionalism permeates industrial organization | Formal: plan<br>Informal: factionalism |
| Exchange (shortage and demand) may be competitive, but not market priced, aiming not to maximize profit but fulfill the plan | Formal: state procurement prices<br>Informal: *zou houmen* | Formal: state or private ownership<br>Informal: "unit ownership" (*danwei suoyouzhi*) |
| Network: Institutional trellis determines both information asymmetry and frequency of communications/interactions | Communications/interactions: central-local, ministerial-local, party-state, *danwei*'s position in the socialist hierarchy (Daqing, TVEs in rich countries) | Info asymmetry: Multiple principals over a *danwei*, manipulation and hoarding to create flexibility and private returns, also moral hazard in overreporting and capacity duplications |

However, this recentralization does not herald the return of broad administrative control over the economy as was the case during the planned economy, but introduces a two-pronged approach of sharpening the macroeconomic leverage that the state needs in its regulatory role on the one hand, while consolidating its effective property rights over a select portion of the state sector on the other.

In industrial governance, the Chinese state has chosen to move to the creation of *chaebol*-style (viz., South Korean family-controlled multinational conglomerates) centralized corporate hierarchies in several strategic sectors as the basic institutional template. By importing Western multidivisional corporate templates and regulated competition, Chinese reformers aim to strengthen centrally administered industrial regulation

private firm; by 2010 it had shot up to 11 times as much. *The Economist*, 6 October 2012, found at http://www.economist.com/node/21564274.

and concentrate revenue collection in the hands of the central government. These top-down institutions reflect the reformers' cumulative judgment of local state agents as inherently opportunistic, prone to shirking and subverting corporate interests, and protectionist against competition from outside the locality. The state has also attempted to establish market prices to govern the new exchange relations through oligopolistic competition and hard budget constraints at the firm level. However, the central government, given the enormity of its fiscal and developmental goals, has hesitated to separate the regulatory from the ownership functions—as in laying out legal-rational competitive guidelines and offering a credible timetable for the selling off of state shares. Part of this difficulty lies in the nature of the bureaucracy, as the State Council needs to decide which agencies or offices will exercise which authorities, and how conflicts of interest and priorities should be adjudicated. Thus the process of selling off of state shares has stalled due to conflicts in the interests of the NDRC, the State-Owned Assets Supervision and Administration Commission, the China Securities Regulatory Commission, the Ministry of Finance, the People's Bank of China, and affected industrial interests.

## The Emerging Post-1997 "Institutional Template": A Case Study of Restructuring the Oil and Petrochemical Industries

From 1998 to 2000, the Chinese oil and petrochemical industries underwent a radical transformation in governance structure.[25] In the fall of 1998, Premier Zhu Rongji directed the Chinese oil and petrochemical sectors to reconsolidate all assets and operations into three integrated and territorially protected national oil corporations (NOCs) in which the state owned the controlling share.[26] Listed in domestic and international stock markets, these NOCs became the darlings of domestic and foreign investors, generating a windfall for the central treasury from their initial public offerings.[27] This section examines the institutional changes that established new authority, exchange, and network relations, and offers illustrative examples

[25] Much of the following text in this section is excerpted and edited from Lin (2006).

[26] The restructuring of oilfields and petrochemical industries from 1998 to 2000 was not only the largest asset reallocation event in the reform era, involving assets valued at 850 billion RMB, but also the most successful, as measured by the scope and speed of reform implementation and short-term financial returns. See various reports in the *South China Morning Post*, chinaonline.com, and www.chinaopg-online.com around the time of PetroChina's and Sinopec's initial public offerings in May and October 2000, respectively. Also see the statement by President of Sinopec Li Yizhong, in *Qiushi* (1 April 2001), pp. 32–34, for an official account of restructuring; Fesheraki Associates (2000); and Fesheraki and Wu (1998, 33–44).

[27] See analysis in China International Capital Corporation Limited (2001).

of remaining ambiguities in the state's dual roles and the limits of these changes in ushering in market forces.

*An Overview of the Restructuring of the Chinese Oil and Petrochemical Sectors*

Unlike prior efforts at enterprise restructuring, this new corporate hierarchy dealt with enduring problems of industrial and regional governance, intraenterprise resource dependency, and firm-level soft-budget constraints with a single blow.[28] At the industrial level, the Chinese reformers established oligopolistic competition between two onshore, integrated oil giants—CNPC/PetroChina and Sinopec, roughly demarcated along the territorial boundary of the Yellow River—plus one offshore company (CNOOC).[29] Nearly all state-owned oilfields, refineries, and petrochemical plants have been incorporated into these national oil corporations; hence, the NOCs corporate headquarters in Beijing manage their exchange relations as intrafirm issues, while responding directly to price signals in the domestic and global markets. The State Council also eliminated the multiple-tier pricing system, replacing it with a peg of centrally administered crude oil prices to various global markets, and liberalizing nearly all prices for finished oil products.[30] The parent holding company also assumed the lion's share of the subsidiaries' cumulative debt, thus providing instant relief from interest payments and ending the vicious cycle of intraenterprise arrears.

At the microeconomic level, the central state has chosen to rely on the organizational effects of a highly centralized "financial principle of control" (Fligstein 1996b, 656–673) based on a few prices and price-derived signals that would bring profit-maximizing discipline into the SOEs.[31] Ac-

[28] For details on the organizational forms and principles of the new national oil corporations, see Lin (2003, chap. 5).

[29] Other preexisting companies, including Sinochem and other smaller trading SOEs, continued to exist, but without their prior policy-defended niche markets or prospect for competition against the major three NOCs. In fact, China National Star Corporation merged with Sinopec in 2000.

[30] Oil and Gas Journal (10 August 1998). The pegged pricing mechanism was revised in October 2001 to reduce transparency and thus predictability for arbitrage players. The new mechanism lets the State Council adjust the crude price based on the price variations in New York, London, and Singapore; the exact formula for adjustment is not publicized. Interview with Bloomberg, Beijing (November 2001). Also see the 20 November 2001 edition of the *South China Morning Post* for negative domestic responses to this new mechanism.

[31] In the formal analysis of sociological and economic institutionalism, the NOCs adopted a centralized "multidivisional form" of industrial governance, under which subsidiaries have been effectively turned into "cost-centers." This represents a dramatic departure from their status as "profit-centers" under the contract responsibility system of 1987–1997. See Freeland (1996, 483–526) and Bolton and Farrell (1990, 803–826), for theoretical overviews of these organizational concepts.

cepting the impossibility of salvaging the whole industry, the reformers have implicitly chosen to maximize the survival chances of a minority of its assets. Thus they created core-listed (hence called "core") subsidiaries that have concentrated the most valuable assets and a relatively lean workforce drawn from the former SOEs. Most of the unprofitable assets and the surplus workforce, including those work units involved in production and technical services and the provision of social services and local public goods, have been lumped under the noncore-unlisted (hence called "noncore") company. Holding equal authority as independent legal entities, core and noncore companies engage in contract-based exchanges mediated in Beijing by their parent companies, which fall directly under State Council supervision. The state, given its new demand for improved control and fiscal extraction as the dominant shareholder, expects the core to generate maximum profit through the exploitation of its asymmetric contractual relationship vis-à-vis the noncore. The noncore bears a large portion of the restructuring costs by offering services to the core at rates that can generate profits for the latter, while reducing its chronic losses through tough measures such as massive layoffs and property rights reform (Lin 2003, chap. 5).

The reorganization of the NOCs figured prominently in the central government's major initiatives since 1997 toward radical industrial restructuring (McNally 2001; Freund 2001). In pushing for shareholding structures, the Chinese central state has initiated two crucial shifts in industrial management: from a decentralized to a centralized approach to marketization, and from administrative to corporate hierarchy in production relations (Ma 1998, 381–97; Lin 2001; Lin and Zhu 2001; Holz 2001). Compared to the bargaining politics in the late 1980s to early 1990s, the 1998 reforms strengthened the hands of central bureaucrats against collective claims of local officials, managers, and workers. Within the corporate hierarchy, the headquarters of NOCs tightened its ownership control through new managerial contracts with specified profit- and cost-reduction targets, financial penalties for breach of contracts, and increased frequency in issuance of fiats that micromanaged various aspects of firm activities that were governed locally during the earlier periods of greater enterprise autonomy.[32] Whether new authority, exchange, and network relations will adjust in tandem to the centralized orientation of formal institutions, or if these components of an institutional template will develop in tension or fail to develop, remains the yardstick for successful institutional transition. We offer some evidence of disparate development in our case study of the pricing reform of oil products next.

[32] For details of implementation, see Lin (2005) and Lin (2006).

*Limits on State-Led Marketization: Crude Pricing by an Oligopoly of National Oil Corporations*

Bringing to a long-anticipated end two decades of the multitrack pricing system, the Chinese state looked forward to the simplicity and depoliticization of price convergence with the global market. However, the NOCs competed in ways that have sent the State Council back to the drawing board. In the first few months of industrial restructuring in 1998, the two biggest NOCs engaged in vicious arbitrage and repricing of oil products in each other's territories. Any semblance of a national market soon disintegrated as chaos over prices swept across China (Qiu 2000). In the end, the State Council was forced to impose an administrative pricing mechanism and guidelines for price fluctuations not unlike those of the socialist era.

Throughout the summer of 1998, global oil prices sank to the nadir of the decade. For the first time in reform history, the domestic administered price of crude oil in China exceeded that of the global price, leading to a sudden and massive spike in the volume of imported crude (Qiu 2000, 7, 31, 54–56). The average cost of domestic crude was around US $11.6 per barrel, while every major global producer was selling oil under $10 per barrel (Qiu 2000, 72). Chinese retailers did everything possible to survive the glut, including outbidding each other in price wars and securing local government protection. As the retail sector, including gasoline stations, was dominated by non-NOC actors such as local states, various non-NOC government agencies, and private entrepreneurs, there existed no practical way to rein in the cutthroat competition. Provincial governments often faced pressure from the State Council and from their constituents to intervene and establish price stability. The Gansu government and oil companies tried to form a market-sharing agreement among all relevant actors to control retail oil prices within the province—only to watch helplessly as the price cartel collapsed in twenty days![33]

On 5 September 1998, the newly established NOCs, CNPC and Sinopec, held a conference to reach "Six Principles" to deal with market instabilities, including provisions for regulating the flows of crude oil between the Northern and Southern territorial niches of the respective national oil corporations. A key point of contention was whether or not and to what extent the oil-consuming Southern region could simply import, more cheaply, rather than rely on buying crude oil from the North. However, each NOC was left to fend for itself within its own region. A central policymaker proclaimed three sure means to stem unruly competition, "Control the supply [of oil], control the supply, and control the supply" (Qiu 2000, 35).

Two weeks later, the State Council issued directives to stop imports of

[33] Major players in Shanxi were able to reach a precarious agreement (Qiu 2000, 38).

finished oil products in surplus—especially diesel and gasoline—in order to temporarily enforce the NOCs market-sharing agreement against the pressures of imports. The corporate headquarters of the NOCs also directed their subsidiaries to scale back production, cap wells, and idle refining capacities. As the NOCs were the biggest victims of the smuggling of refined oil products, they became the biggest beneficiaries of the antismuggling campaign. Profitability shot up immediately, but at the expense of raised input costs for refineries and increasing dissension within the hierarchy of the oil corporations and between central and local states. Many smugglers were powerful local politicians and bureaucrats or even managers within the NOCs (Qiu 2000, 84). For instance, the CEO of the Fuzhou Subsidiary of the Fujian Oil Company personally orchestrated the smuggling of 5,000 tons of diesel in February 1998. Recipients of import licenses often abused their power to import in excess of their allotted quota: customs officers found an oil tanker in Hangzhou that was carrying 39,000 tons of diesel, of which only 9,000 was permitted by the license. Finally, David Wank (2002) has investigated the notorious Xiamen case that implicated the highest-level provincial and Beijing officials. These publicized cases amounted to no more than the tip of the iceberg.[34]

By January 1999, the agreement between CNPC and Sinopec had all but disintegrated. Oilfields and retailers in the Northern oil-producing regions had private incentives to sell their oil to Southern regions, often at heavily discounted prices, to steal market share away from their competitors and importers. In a perverse turn of events, Southern retailers would ship the cheap oil back to the North and sell it at a higher price. For example, the local wholesale price of crude in Liaoning Province was 170 RMB lower than the state-stipulated, cartelized price, but 150 RMB above the price of "countercurrent" oil from the South (Qi 2000, 58). The shock to economic planners and NOCs' corporate headquarters in Beijing could not be understated.

The NOCs entered another market-sharing agreement on March 1999. Forced to rethink its role in setting prices of crude and other oil products, the state had taken several regressive steps in revamping the price mechanism since 1997. The initial formula contained a state-determined "market price" for various grades of crude and processed oil, which would be pegged to a monthly average of the Singapore indices for the same products, and a flexible "premium" that accounted for transportation and other local cost differentials.[35] However, the predictability of this peg

[34] For aggregate smuggling figures for 1997, as estimated by customs officials, see Qiu (2000, 89–90).

[35] For details of this formula, see *Oil and Gas Journal*, 10 August 1998.

mechanism prompted speculative behavior from nonstate actors prior to the declaration of official prices, thus undermining price stability and the monopolistic rent of the national oil corporations. In late 2001, the State Council switched to a different price-setting mechanism of considerably less clarity, which has been widely interpreted by foreign and domestic analysts and nonstate players as grossly biased in favor of the NOCs and hence antimarket in essence.[36] Problems in establishing new price-setting authorities and competitive rules of exchange through oligopolistic market structures have been documented in other industrial sectors by Chung (2003) and Kennedy (2003). The past four years of unusually high global crude oil prices have exposed problems in the current system of state-administered prices, generating upstream-downstream tensions between domestic oil producers and refineries and consumers, supply disruptions in Guangdong, and intense lobbying by NOCs for price hikes. In light of the previously described formative experience in price liberalization, the NDRC has stuck to its guns in defending its authority in controlling prices, only promising greater responsiveness to global price fluctuations within the existing framework.[37]

## Conclusion

We have attempted in this chapter to chart the evolution of China's "socialist market" as it has emerged in the course of the transformation of the Chinese industrial sector since the Third Plenum of the Eleventh Party Congress in December 1978. We argue that this transformation can be usefully analyzed as a change in "institutional templates" organized around authority, exchange, and informal networking, depending on the stage of reforms. These three "principles" have varied in form and relative priority as the state has shifted its role in the course of reform from ownership and command planning to market regulation. The early reform period (after a brief initial period of plan revival, discarded in the early 1980s) emphasized decentralization and marketization to grow beyond a centrally planned institutional context. The post-Tiananmen period has shifted to recentralized administrative and fiscal regulation of a marketed economy. The ultimate goal is "big society, small state," at once strengthening

[36] Passed in October 2001, the new mechanism lets the State Council (SC) adjust the price of finished oil products if the prices in New York (10% of weighting of SC formula), London (30%), and Singapore (60%) vary above a certain undisclosed margin (Interview with Bloomberg, Beijing [November 2001]). Also see *South China Morning Post*, 20 November 2001 for a sample of critical domestic responses to the new mechanism.

[37] "China Signals It Will Not Abandon Low Oil Prices," Agence France Presse (AFP), 26 September 2005; "China To Take Small Steps Towards Oil Price Liberalization–Analysts," AFP, 1 March 2006.

the prestige and power of that state while limiting its functional span of control. In most macroeconomic and political respects this transformation seems to have been remarkably successful. The polity has become more quiescent, internecine elite disputes less tense and explosive, and the economic business cycle less choppy, while GDP growth remains high.

Yet we emerge from our case study of the oil and petrochemical sectors with a caveat. Chinese reformers counted on limited competition—through oligopoly at the industrial level or between subsidiaries within the firm—to create market prices while ensuring the survival of national firms. However, serious disruptions in preexisting network relations hampered the transition to the intended equilibrium based on exchange principles. Losers among the new institutions used informal networks to appeal to authority and to their exchange partners, prompting at least provisory return to the authority principle of central price setting. Clearly demonstrating its limited tolerance for unbridled price competition, the central state chose to intervene at the first sign of disruptive aspects of the exchange principle and the resurgence of informal network relations potentially upsetting social stability priorities.

This is not to say that the network principle is a consistent or reliable partner of the authority principle. The network is also exploited in quasi-market transactions between bureaucrats and entrepreneurs or other clients in various forms of local corruption or investment. The network principle is essentially opportunistic, submitting to the force majeure in any given context. After the brutal crackdown on the protest movement at Tiananmen, the political authorities clearly had the upper hand, which they have endeavored to retain. While initiative has shifted between authority and exchange principles, the network has consistently functioned in an intermediary capacity, providing informal space to adjust between political command and market rationality.

The Chinese planners have not abandoned their institutional template of exercising ownership control by fiat in a corporate hierarchy that is nested in exchange relations among its subsidiaries and other state-controlled corporations. It has however reinforced, at least in certain strategic sectors, an oligopolistic sectoral milieu designed to constrain cutthroat competition.[38] While no longer an owner or a command planner, this authoritarian state clearly takes an expansive view of its market regulatory responsibility.

[38] See government work report by Premier Wen Jiabao at the Fourth Session of the Tenth National People's Congress on 5 March 2006, in which Wen emphasized the urgency of corporate restructuring. Full text available in English translation at http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/english/2006-03/14/content_4307484.htm.

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