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II POLITICS, LEGAL-RATIONAL INSTITUTIONS, AND CORRUPTION

4 On Politicized Capitalism

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Transformative institutional change in departures from state socialism relies not only on evolutionary bottom-up processes but also on sustained intervention by the state to build a new institutional framework. The state must simultaneously dismantle the institutions of central planning and put in place the requisite rules of competition and cooperation of a capitalist economy. The shift of control rights is often retarded, however, by mutually reinforcing interests that perpetuate a close relationship between the state and the firm. On the one hand, state actors are rarely willing to institute a new economic system that completely deprives them of direct control rights at the firm level. On the other hand, managers often prefer the continuation of direct state-firm linkages to gain access to resources in a highly insecure and rapidly changing business environment. As a result, "there is still a much different atmosphere of interaction between government and individual economic agents in ex-socialist countries than in countries with a long tradition of free markets" (Murrell 1996:32).

We call this type of institutional order *politicized capitalism,* where state actors set the regulatory framework *and* remain directly involved in guiding transactions at the firm level. In transitions from state socialism, politicized capitalism is a hybrid order comprising recombinant institutional elements, preexisting and emergent organizational forms, and networks oriented to establishing a market economy (Stark 1996; Nee 2005). It is a mixed economy in which market liberalization and ownership reform are unfinished, preserving partial control rights by the state as both a redistributive allocator and an owner of productive assets. Although the new rules of a market economy impose formal limits on state interventions in the firm, the defining feature of politicized capitalism is the overlap of political and economic markets and the absence of clearly defined state-firm boundaries. The central dilemma faced by reformers is to promote market-driven economic growth within the constraints imposed by competing demands of political and economic actors.

Politicized capitalism emerged in China in the 1980s in the course of market transition (Zhou 2000). This chapter examines the structural tensions between state intervention and marketization in the emergence of China's new capitalist economy. Apart from occasional rural markets, the market as a coordinating mechanism of production and distribution was virtually nonexistent before the start of economic reform in 1978. Under Mao, markets and private ownership of productive assets were eliminated and replaced by a vast, multitiered national system of nonmarket bureaucratic allocation. The characteristic feature of the Maoist-era institutional order was a pervasive reliance on political controls in a redistributive economy where the communist party and government managed all dimensions of production and distribution (Schurmann 1968; Whyte and Parish 1984; Walder 1986). Market transition is a dynamic transformative process characterized by a diminishing role of central planning and increasing significance of market institutions in economic life. Figure 4-1 provides a conceptual map, with ideal-type institutional orders arrayed by the extent to which market versus planning and private versus state ownership of productive assets enable, motivate, and guide economic activity. Politicized capitalism is a hybrid institutional order in which recombinant elements of central planning and state control combine and interact with emergent markets and private ownership forms. It comprises institutional arrangements patched together in ad hoc improvisations to address the needs and demands arising from rapid market-oriented economic growth.

The question we explore here is whether politicized capitalism embodies a Nash-like equilibrium, the stable institutional order at the culmination of departures from central planning. In this case, the defining feature of politicized capitalism persists in the close overlap of political and economic markets wherein the state is actively involved at the firm level. Alternatively, if politicized capitalism is itself an embodiment of the organizational dynamics of market transition, constructed from recombinant institutional elements to facilitate the rise of a capitalist economy, as Greif (2006) has detailed for

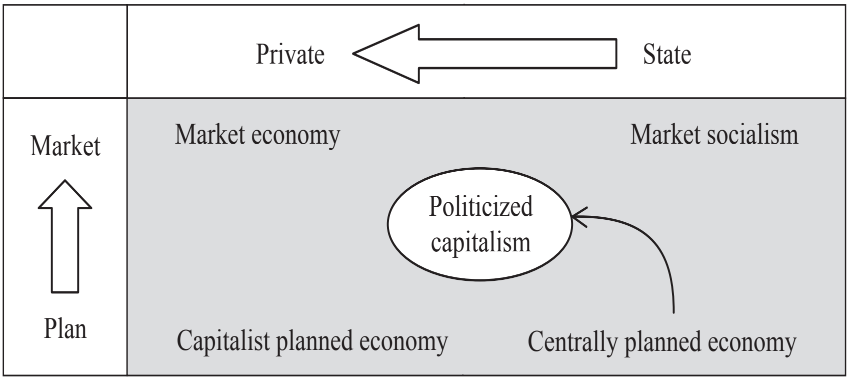

FIGURE 4-1 Politicized Capitalism as a Transformative Economic Order

Europe, we predict that political interference in economic life declines in industrial sectors and regions to the extent that an emergent market economy replaces the centrally planned economy (Nee 1989, 1992). If this alternative scenario holds, it would be confirmed by evidence of decline in the politicized nature of economic decisions in state-firm relations as the role of the state shifts to greater emphasis on building market institutions, i.e., property rights, legal system, market structures.

China's politicized capitalism bears a strong family resemblance to other developmental states in East Asia in its reliance on state intervention to promote transformative economic growth. The goal of the state is to wield state power at the national and local levels to enable, motivate, and guide economic development in order to "catch up" with the advanced industrial economies. In China even more than in the other East Asian developmental states, growth and economic modernization are the basis of state power, providing legitimacy for the continuation of the Chinese Communist Party (CCP) leadership. A strategy of transition has evolved that addresses the interest of reformers in safeguarding the power and privileges of the political elite even while implementing wide-ranging economic reforms that both reduce the scope of state managerial controls over production and distribution and expand the role of the market as a mechanism to motivate and guide economic growth.

Politicized capitalism as a hybrid order permeates the transition economy, but its role in guiding economic action is a variable feature of economic life subject to empirical analysis. The remainder of the chapter is organized as follows: In the following sections we discuss core features of China's politicized capitalism as a distinct type of developmental state and then give an overview of China's growth promoting macro-policies. We then explore state interventionism at the firm level as a core feature of China's hybrid capitalist system. We focus on discrete empirical studies exploring two types of state interventions: (1) state assistance in the firm's external transactions, such as government assistance in securing loans and (2) state interventionism in corporate governance inside the firm. In conclusion, we offer an outlook on the expected development of China's institutional order of politicized capitalism.

Overall, we report evidence on the persistence of state involvement at the firm level. Our evidence reveals a rather complex situation: On the one hand, direct state involvement in decision making at the firm level has a negative effect on performance; on the other hand, firms will not openly reject state involvement because they still rely on state actors to ease resource constraints of China's regulated markets. Because market transition creates conditions of decreasing resource dependence on the state, politicized capitalism is inherently in disequilibrium (Nee 1989; Nee and Lian 1994). Where private firms compete in open markets, entrepreneurs prefer to be free of the communist party. A tipping point is reached when a critical mass of entrepreneurs no longer depends on state-controlled resources, and growing reliance on tax revenues contributed by private enterprises reinforces incentives for government to make resource allocation decisions based on assessment of their effects on local economic performance and on their prospects for career mobility.

Politicized Capitalism as an Institutional Order

China's economic miracle has riveted attention on the positive role of the state in promoting transformative economic development. As Stiglitz observes, "The contrast between Russia's transition, as engineered by the international economic institutions, and that of China, designed by itself, could not be greater: While in 1990 China's gross domestic product (GDP) was 60 percent that of Russia, by the end of the decade the numbers had been reversed. While Russia saw an unprecedented increase in poverty China saw an unprecedented decrease" (2002:6). Per capita GDP grew from $100 to $944 (constant prices 1995) between 1978 and 2002. The market capitalization of firms listed on China's stock exchanges increased from 1 percent of the GDP in 1992 to 37 percent by 2002. Exports increased from $39 billion in 1978 to $470 billion per annum in 2002 (constant prices 1995). Annual net foreign direct investments grew from $386 million in 1982 to $46.8 billion in 2002 (World Bank

2004). China thus becomes the latest entry in the pantheon of successful developmental states, along with South Korea, Taiwan, and Japan (Stiglitz 2002).

In its core features, China's current economic system of politicized capitalism resembles that in other East Asian societies in the early stages of economic takeoff. Direct state intervention at the firm level is widespread, and the state's guiding hand in promoting national growth remains visible. Two mutually reinforcing institutional changes frame the interactions between the local state bureaucracy and firm-level economic actors: a) modernization of the party and government bureaucracy and b) fiscal decentralization.

Strengthening Bureaucratic Capacity after Mao

Modernization of the state bureaucracy has been the government's priority throughout the reform period. Mao's decade-long Cultural Revolution crippled China's state apparatus. It politicized the structure of bureaucratic career mobility, severely undermining rules and norms of merit-based recruitment and promotion. The predominance of "red" cadres recruited and promoted on the basis of their political activism reduced the state's capability to perform routine administrative tasks. Demoralization and the accompanying breakdown of rational-legal norms and procedures resulted in reliance on personal connections (*guanxi*) in the functioning of public administration. Given widespread local cadre opposition at the outset of economic reform, reform leaders soon realized that restoring the efficacy of the state bureaucracy was essential to success in their ambitious reforms (Nee 2000).

Administrative reforms in the 1980s introduced strict retirement ages for government officials and a one-time buyout strategy to retire old veterans as a means to push out Maoist bureaucrats who were impeding progress in market-oriented economic reforms. Early retirement was aimed at reducing bureaucratic inertia and commitment to the old planning mentality of state socialism (Lipton and Sachs 1990; Murrell 1996). Reformers also sought to build a modernized bureaucracy by implementing merit-based entrance exams and promotion schemes to reinforce incentives to improve local economic development (Li 1998; Li and Lian 1999). College education and technical qualifications became general entrance criteria. Many elite bureaucrats are recruited with engineering and public administration degrees, reflecting the emphasis on technical training and expertise.

As a result of these administrative reforms, government regulations and procedural guidelines have become more and more precise and transparent (Yao 2001). This has increased the predictability of bureaucratic decisions and reduced uncertainty with respect to government policy and regulatory practices. The passage in 2005 of a comprehensive legal code governing civil service culminated this two-decade-long concerted effort by reform leaders to modernize China's state bureaucracy. The new civil service law sets forth strict, rule-governed performance guidelines with respect to appropriate conduct. Public announcement of openings, reliance on scores in civil service examinations to recruit candidates, annual performance reviews, competitive examinations in routine promotions, and monitoring by the personnel department have been institutionalized at all levels of the national bureaucracy.

Notwithstanding national reform measures, the quality of the state bureaucracy varies considerably across regions and localities in China. Progress in building a modern bureaucracy has been uneven and inconsistent. In poor, rural hinterland regions, corruption is an incorrigible feature of local public administration. Predatory behavior on the part of government officials is reflected in the routine use of local state administration to extract surplus from peasants through local levies and taxes, hosting of banquets at the expense of entrepreneurs, requisition of farmland for use by developers without adequate compensation to the farmers, and official tolerance of environmental degradation. Moreover, local bureaucrats routinely intervene as predatory agents under the cover of promoting economic development. Widespread public perception of abuse of power and corruption has contributed to a sharp increase in the frequency and contentiousness of local protests and rebellions. The annual number of mass incidents is on the rise, with around 87,000 registered protests and petitions in 2005 (Li 2006). Despite the national guidelines upholding merit-based recruitment and promotions of government and party bureaucrats, the poor hinterland regions lag far behind the coastal provinces in the formal training and technical competence of civil servants.

Max Weber ([1922] 1978) observed that the rise of market capitalism and the development of modern bureaucracy are closely coupled institutional processes. As in the rise of capitalism in the West, modernization of the civil service in China has made the most rapid progress in the prosperous private enterprise economy of the coastal regions. In the course of two decades of reform, the Yangzi Delta region, an epicenter of Chinese capitalism, has attained a level of bureaucratic efficiency comparable with Western industrialized countries. According to the *World Competitiveness Yearbook,* covering 61 countries and economic regions worldwide, Zhejiang province was ranked 17 in terms of bureaucratic efficiency[1] (score 4.31) in 2006, ahead of the United

States (4.39) and Australia (4.35). Although China's overall score is much lower, ranking 35, it ranks higher than some European industrialized countries including Germany, the United Kingdom, Belgium, and Italy. Corruption and bribe taking are also far less pronounced in Zhejiang province (rank 36; scoring higher than the Czech Republic and Hungary, Europe's successful transition economies) than in China as a whole (rank 46). Recruitment of elite bureaucrats relies on open competitive national searches. Recruiters are even sent to North America to interview Chinese students with postgraduate degrees from U.S. and Canadian universities for specific key positions. Short-term training workshops in the West are increasingly popular and involve the major elite universities.

Though traditional China was the first to institute national civil service examinations in recruiting scholar-officials for the imperial bureaucracy, the spirit of the imperial bureaucracy was shaped by generalists, the elite literati committed to Confucian moral and ethical teaching. It was not until the contemporary era that rational-legal norms and approach to public administration have gained legitimacy as the defining spirit for the government bureaucracy. Rather than generalists, as in the "red" cadres of the Cultural Revolution era, today's elite bureaucrats are recruited for their technical expertise and promoted for their performance as technocrats. Competition in internal bureaucratic promotion is intense and the standards of annual performance reviews are high but transparent, allowing fair evaluations and predictable career paths. Through strict implementation of national rules and standards, the provincial government of Zhejiang province has successfully reestablished the high social status government officials traditionally held in China. With its emphasis on merit-based recruitment and promotion, Hangzhou municipal government has built a modern bureaucracy that uses state-of-the-art knowledge in public administration and related fields, typically favoring indirect means of governance—tax policy, regulatory action—over direct interventions in the firm.

The building blocks of Zhejiang's bureaucratic modernization are promulgated in China's civil service laws and preceding regulations. The particular success may lie in a specific esprit de corps that Zhejiang's government succeeded in establishing. Notwithstanding, Zhejiang's success in building an effective state bureaucracy should not diverge much from other areas of China where private enterprise and markets have gained a critical mass. Overall, the state bureaucracy is undergoing a process of dynamic transformation from a Maoist-era politicized state apparatus to a technocratic bureaucracy that emphasizes higher education and technical expertise in the recruitment and promotion of bureaucrats. Secure government employment coupled with high social status and attractive benefits serve as incentive to avoid malfeasance. As this transformation progresses, politicized capitalism is in disequilibrium as the rise of a private-enterprise economy and competitive markets rapidly diminishes the relative industrial output of state-owned enterprises (SOEs) and drives the Chinese state inexorably toward less direct interventions at the firm-level, and indirect instruments such as taxation and credit policies.

Fiscal Federalism

The theory of state and local finance has long stressed the disciplining effect of fiscal decentralization on government activities and the provision of public goods. Qian and Roland (1998) offer a model to analyze the relationships among the organization of the state, economic policies, and the tightness of fiscal budget constraints. They identify two main mechanisms that may constrain predatory political interference in the economy. First, under the assumption of factor mobility, a federalist system introduces competition among local governments, which increases opportunity costs of bailouts and any activities leading to inferior enterprise performance (Weingast 1995). If local government jurisdictions fail to provide a hospitable business environment, they face poor chances of attracting resources needed to enhance economic prosperity. Competition in a federalist system eventually limits discretionary authority, predatory behavior, and rent-seeking. Second, in federal systems, fiscal decentralization may harden budget constraints of jurisdictions and provide incentives for efficiency-oriented local activities. Local governments compete to build a business environment favorable to private capital.

Indeed, China's policy of fiscal decentralization has constituted a key institutional innovation aimed at strengthening economic incentives of municipal and provincial governments to support market-oriented economic reform. According to the fiscal revenue-sharing system, lower-level governments have the obligation to submit a fixed proportion of fiscal revenues to their superior government unit, while retaining the residual for their own budget. Given that tax revenues are positively correlated with firm performance, local bureaucrats have an incentive to do what they can to assure that local firms prosper (Montinola et al. 1995; Li 1998). Fiscal federalism has thus developed into a major driving force of economic reforms in China. With increasing financial independence of local governments, revenue-generating reforms have gained in importance, whereas the incentive for local governments to maintain elements of the old socialist command economy has declined.

Increasing financial responsibilities and hardening budget constraints imposed strong pressure on government to privatize the local economies, given low profitability, weak tax revenues, and increasing state subsidies needed to maintain loss-making state industries, and the superior economic performance of private firms over state-owned firms. Local governments developed a strong interest in divesting loss-making state-owned firms. Figure 4-2 depicts the close negative bivariate relation between state-owned production and local revenues and more specifically between state-owned industrial production and corporate tax income at the provincial level between 1995 and 2004. It shows that provinces that have declining industrial production from state-owned enterprises relative to nonstate firms also have higher corporate tax revenues.

Provincial and municipal governments responded to increasing economic pressure by accelerating privatization and divestiture of state-owned assets. Following China's official policy, *"zhua da, fangxiao"* (grasp the big ones and let the small ones free), the 1990s saw an unprecedented increase in the pace of privatization of these enterprises. Small- and medium-size firms were sold in the form of manager or employee buyouts or auctioned off, whereas big state corporations of the so-called sensible key sectors were partially privatized and corporatized, with many of them being listed at one of China's two stock exchanges. As a consequence, the number of state-owned enterprises was reduced by more than 70 percent from 113,000 to 31,000 and total national employment in them was reduced from 110 million to 64 million between 1996 and 2004, while their total production value was stabilized at around 35 percent of gross industrial output. Within the nonstate economy, private sector development emerged as the most dynamic growth engine of China's economy. By the end of 2004, registered employment in the private sector already reached 96 million with an annual production growth of 40 percent, out-competing all other ownership forms (*China State Statistical Yearbook 2005*).

Figure 4-3 illustrates the close parallel development of waning state-owned industrial production and increasing market liberalization based on pooled provincial-level data covering the period between 1997 and 2003. It confirms that as the market economy expands, the gross industrial output contributed

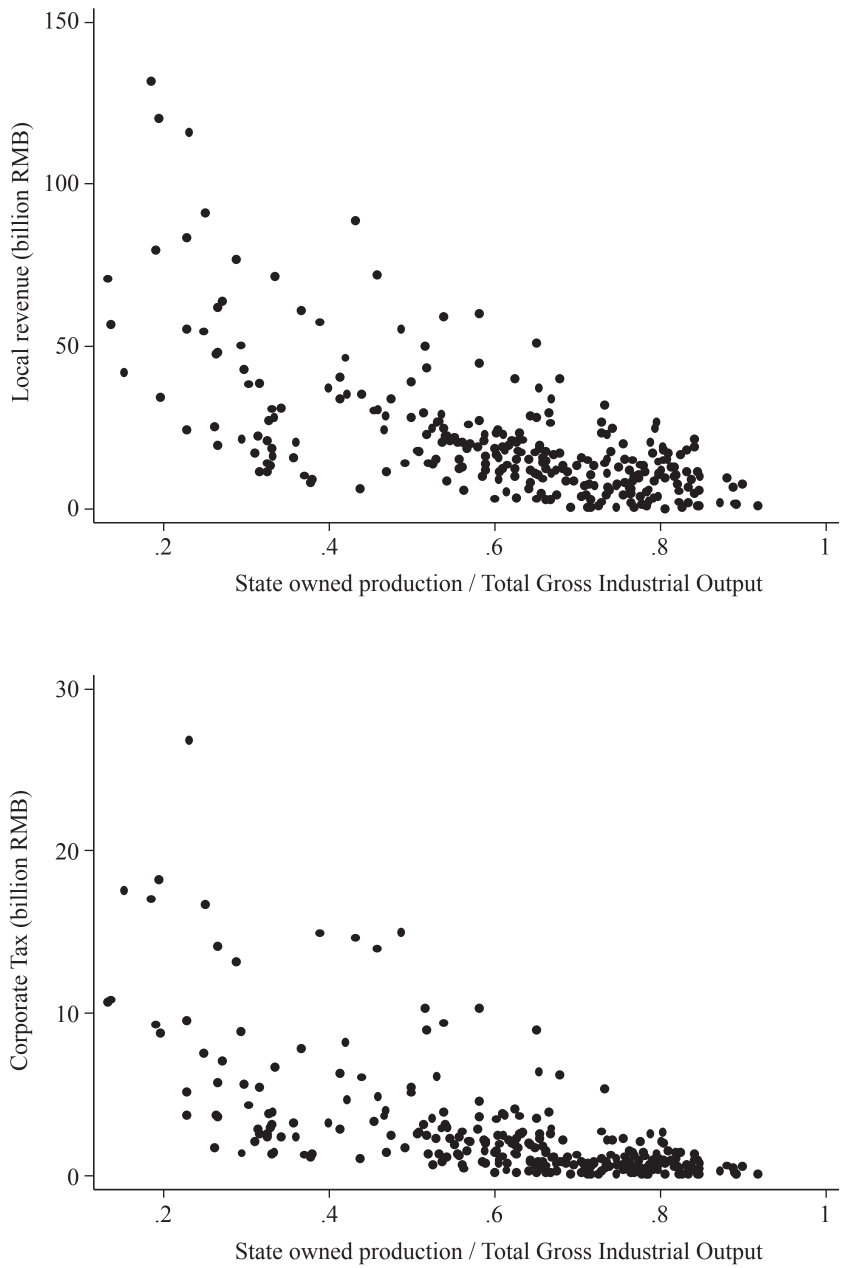

FIGURE 4-2 State-Owned Production and Provincial Revenues, 1995–2004

SOURCE: National Bureau of Statistics of China.

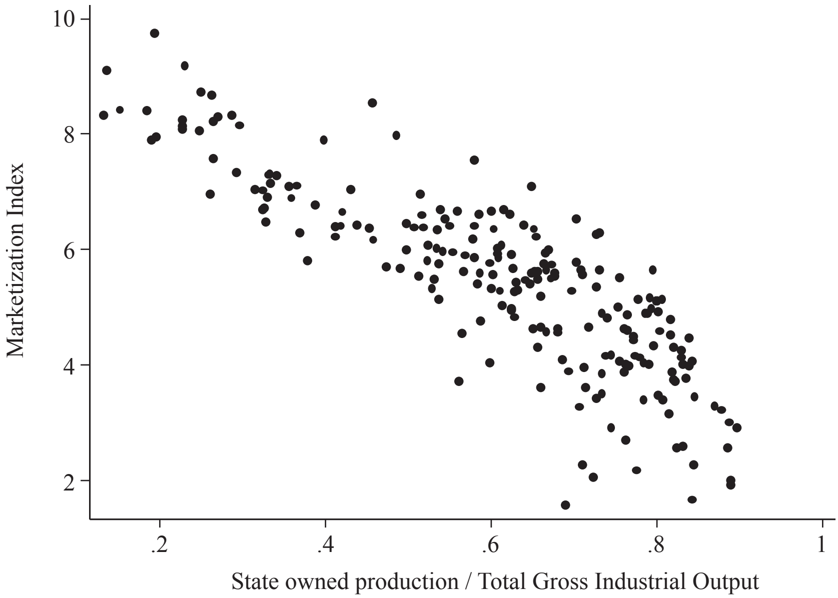

FIGURE 4-3 Bivariate Relation Between Provincial State-Owned Enterprise-Production/Gross Industrial Output and Marketization Index, 1997–2003

SOURCE: Data from National Bureau of Statistics of China; Fan and Wang (2003).

by state-owned enterprises declines. In other words, as predicted, in market transitions the greater the size of the market economy, the less state-owned productive assets can compete with private-ownership forms in the production of industrial output (Nee 1992; Naughton 1995). We infer from Figure 4-3 that the state-owned sector is strongest in regions of the transition economy where competitive markets are still subordinate to the state in the allocation of scarce resources.

Overview of Growth Promoting Industrial Policies

It is obvious that the changing relative contribution by state-owned enterprise and private enterprise drives a dynamic transition in the role of the state towards the custodial and midwife role of the East Asian developmental state. Like Taiwan, South Korea, and Singapore, China has instituted an overall growth strategy of modernization and technological innovation that provides an institutional and political framework for intense collaboration and cooperation between the political and the business elites. The first so-called industrial policy (*chanye zhengce*) guidelines were implemented in 1989,[2] when the government perceived that the old planning apparatus was no longer suitable to steer economic priorities—particularly industrial development—in China's economic development. Since then, the government has frequently revised and reformulated industrial priorities in an effort to single out future winners and losers in the ongoing structural transformation of the economy. The government seeks to create an environment conducive to the growth of large-scale firms that can eventually turn into big, multinational players who establish global brand names. Common instruments such as market entry regulation, taxation, and loan decisions are part of the state's tool kit to influence the direction of structural transformation (Lu 2000). In this sense, China's industrial policy is also actively involved in shaping market structures.

In parallel, the Chinese government developed a science and technology program that relies on the mechanism of central planning and resource allocation. Major institutions in charge of formulating the national science and technology (S&T) plans are the State Science and Technology Commission and the State Economic and Trade Commission. A set of four mutually complementary S&T programs builds the framework of China's national technology policy.[3] Each program supports a close science-business interface to secure innovation activities with good prospects for productivity growth and to maximize the commercialization of research and development (R&D) output. While the individual programs follow a set of distinct core objectives, with specific tools to promote technological development, the planning institutions gradually adjust national priorities and targeted research goals in response to the changing overall state development goals. Concurrent to the structural changes within China's research landscape, the central government has gradually increased the relative role of R&D policies. In 1995, the "Decision on accelerating scientific and technological progress" formulated a target value of 1.5 percent of GDP for national S&T expenditures. Although China has not yet reached its target value, the recent increase of R&D expenditures over the last few years is indeed impressive. Between 1999 and 2003 the annual R&D expenditures increased from 0.8 percent to 1.3 percent, meanwhile surpassing even the average value of the EU-15 countries. The majority of R&D expenditures accrue in the business sector, followed by R&D institutes and universities. In parallel, the proportion of scientists and engineers in the overall S&T population increased significantly from 54 percent to 69 percent between 1999 and 2003 (National Bureau of Statistics of China 2004).

The state's modernization efforts are supported by massive investments in China's system of higher education. Overall educational funds increased from 2.8 percent of GDP in 1991 to 5.2 percent in 2002. Government funding equaled 3.3 percent of GDP in 2002, and the remaining educational funds were generated by tuition fees and nongovernment funding organizations (State Statistical Bureau 2004). In terms of public expenditure of GDP on education, China is comparable with Singapore and ranks only slightly lower than Japan and Korea. Institutions of higher education enjoy special attention and received 23 percent of government appropriations for education in 2002. The annual number of university graduates increased from only 0.16 million in 1978 at the start of the reform period to 2.39 million in 2004. Due to China's centralized system of university entry exams, the structural composition of university graduates is closely aligned with the specific needs of China's economic development. About 35 percent of China's university graduates hold a degree in engineering, 15 percent in business administration, and another 9 percent in natural sciences (National Bureau of Statistics of China 2005). This makes China the biggest producer of engineers worldwide (with about 800,000 graduates in 2004).

In contrast to Japan's technological catching-up process, which basically relied on the country's own development strength, China's reformers have embraced foreign technology to jump-start national economic development. Foreign direct investment (FDIs) emerged as a core element of the national reform agenda from the outset of economic reforms in the late 1970s. The state promoted FDI to serve two complementary purposes: First, foreign investments obviously alleviated China's capital constraint; second, the new FDI policies were designed specifically to speed the country's technological catching-up process through channels such as reverse engineering, skilled labor turnovers, and demonstration effects. Special economic zones with generous tax and fiscal incentives not only facilitated the inflow of scarce capital, but also served as entry ports for advanced technologies, Western-style management techniques, and organizational blueprints. Countrywide development of technology parks and development zones facilitated an immense inflow of FDIs across China. Meanwhile, China ranks number one worldwide among FDI recipient countries with an FDI inflow of 153 billion USD in 2004 (State Statistical Bureau 2005). Steered by specific investment incentive schemes, FDIs gradually shifted from labor-intensive technologies toward capital- and knowledge-intensive technologies. Local content regulations guaranteed that national firms benefited from the growing FDI inflow as suppliers of input factors and machinery. More recently, local content regulations even included R&D activities in order to deepen the technological exchange between multinational companies and local firms.

Politicized Capitalism and the Firm

While the aforementioned programs represent many of the standard features of national policies of developmental states (Evans 1995), state activities in China's politicized capitalism typically go beyond the provision of growth-promoting strategies that indirectly encourage firm development. Due to the overlap of political and economic markets in politicized capitalism, state actors also enjoy opportunities to directly interfere at the firm level. Figure 4-4 highlights the dual role of the party-state and its representatives, as the rule-setting body and as actively involved in firm transactions. In *politicized capitalism,* the firm not only responds to market signals, but its performance and economic success are also affected by its relations with state representatives and the extent and quality of government involvement within the firm. Due to weak legal and political checks and balances, legal limits to political interference are largely absent. Although China has invested tremendous efforts to bring its business laws and regulations into accordance with Western practices, legal institutions are still weak and provide little protection against state interference. A core feature of China's legal reforms is to build legitimacy for economic reforms and sustain transformative economic growth without affecting the CCP's monopoly on political power. Hence, the legal system is still not independent from the Communist Party, and local courts remain in a subordinate position in relation to the local party committees (Findlay 1999).

One can differentiate between two distinct types of direct state interventions at the firm level:

a) State involvement in market transactions of the firm, particularly to assist and support business deals in state-controlled markets, and b) Direct state involvement in the firm's corporate governance.

State Involvement in Market Transactions

State involvement as a third party in economic transactions is widespread when firms operate in partially liberalized or state-controlled markets. In such

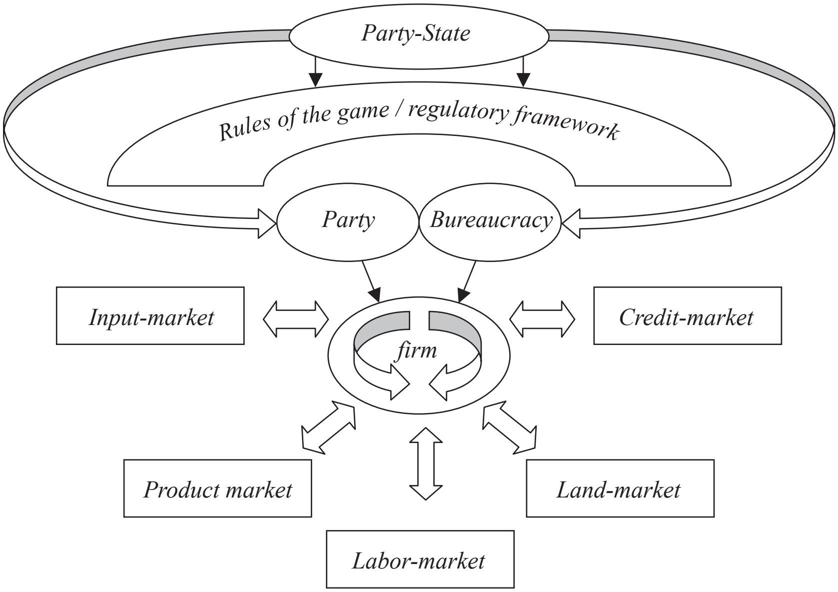

FIGURE 4-4 The Firm in Politicized Capitalism

cases, resource dependence theory predicts a voluntary construction of clientelist ties between firms and government in an effort to alleviate and mitigate resource constraints. Political capital becomes an important asset and may affect a firm's success in securing business deals. Examples of state-controlled or highly regulated markets are those for land-use rights, for public construction projects, for credit and for capital, as well as specific state production monopolies such as tobacco and energy. Outcomes in these markets are not fully determined through market mechanisms bringing supply and demand into equilibrium; instead, business transactions are still heavily regulated and controlled by the state. Hence, political capital embodied in personal relationships between political and economic actors may provide crucial information advantages or provide legitimacy and credibility for entrepreneurs that eventually help to secure a business deal. By contrast, in competitive markets, market outcomes are determined by the price mechanism; hence, the economic benefits of political ties decrease. Market transition theory predicts that the importance of political connections for business success is negatively correlated with the degree of economic liberalization and marketization (Nee 1989; Bian and Logan 1996). Hence, in heavily state-regulated industrial sectors and regions, entrepreneurs must cultivate personal connections with powerful government bureaucrats to gain reliable access to resources and protect their firms from predatory interventions (Wank 1996; Xin and Pearce 1996; Peng and Luo 2000).

In our field research involving 80 interviews with private entrepreneurs in the Yangzi Delta in the summer and fall of 2005, we found rich evidence supporting the close connection between the extent of state control and the value of political capital. Many entrepreneurs whose businesses competed in free markets told us they do not invest in political capital. The general manager of a computer company, for instance, clearly rejected the idea of playing the "game of politics," and explained, "In my sector, the government cannot give me much, not much tax breaks, and not much government contracts." By contrast, entrepreneurs in state-controlled and highly regulated markets, such as the construction business, told us they invest considerable efforts to establish close personal ties with the political elite. Especially for entrepreneurs who depend on government contracts for their business, having strong political ties with government is often the decisive factor in business success. One entrepreneur in the water purification business in the Yangzi Delta remarked: "Competitive bidding is just a form. It doesn't involve the entire process in terms of results . . . Political connections are still as important as before . . . If some senior government official gives a signal we will get the project. Sometimes we lose bids, because someone else gets the nod from a senior official."[4] Government interference and influence in regulated markets often goes well beyond the legal limits and involves corruption and bribery. A Chinese study conducted in 2004 reveals that about 80 percent of illegal land-use cases can be attributed to local government malfeasance (Li 2006).

Resource constraints and the need to secure the "helping hand" of government are particularly important for firms beyond a certain critical size. With size, firm vulnerability increases, due both to increasing rent-seeking activities of government officials and to resource dependence, so that good government relations become a crucial factor in doing business. As one interviewee pointed out, "Once you are big, you are in trouble. You must have good relationships with the government then . . . If the party wants you to die, you have no way to live."[5] Managers and entrepreneurs develop and cultivate political capital through the informal pursuit of old friendships with government officials in social gatherings and family visits (particularly managers who held previous positions in the government), and through financial donations to support government projects. There is also the formal inclusion of government officials on so-called expert committees formed as a consulting body to provide guidance in important firm decisions. Entrepreneurs in regulated markets tend to make significant financial investments in maintaining political connections. Our interviewees indicated that "social expenditures" of up to 1 percent of the contract value are expected; the investment might be a higher percentage in smaller deals.[6]

Our anecdotal evidence from interviews with entrepreneurs in the Yangzi Delta region is supported by data from the World Bank's Investment Climate Survey of 2,400 firms conducted in 2003 in 18 cities in China. The survey was conducted in two parts: one to be answered by the firm's CEO and the other by the CFO or accountant. Using this World Bank dataset, we compare the state's role in assisting business transactions in both types of market structures. As an example of a state-controlled market, we focus on China's credit market, which represents one of the least-reformed sectors of China's transition economy. For a case study of competitive markets, we chose China's product market, which (with few exceptions, i.e., state monopolies in tobacco and energy) was the first market to be liberalized in China's economic reforms.

To assess the effect of political connections in both market structures we chose to compare the effect of political capital as measured by direct government assistance to the firm and the involvement of a party official in the firm's management. The party and government can best be described as a multiplex principal-agent relationship, with the party being the principal and the government agencies representing diverse agents (Shirk 1992, 1993). The local party committees can therefore offer access to most administrative bureaus at the local level. For instance, the party can provide an indispensable network outside of which bank credit is much more difficult to access. Membership in the CCP is often regarded as a minimum requirement for a career as a professional manager—particularly in state-owned enterprises and in private firms that exceed a certain size and influence. A CEO with active involvement as a party secretary, vice party secretary, or party committee member signals a closer and stronger party affiliation. According to the Investment Climate Survey, more than 42 percent of the surveyed firms actually have a CEO who holds an office in the CCP. Some regional variation can be observed, with more liberalized and reformed areas showing a smaller proportion of politically active CEOs and less-liberalized, economically backward regions showing a higher proportion.

The banking sector is still dominated by four state-owned commercial banks and three political banks. Although the state banks have been joined by 12 joint-equity banks, about 90 regional city banks and private banks like the

Minsheng Bank (founded in 1996), the oligopolist structure of the Chinese banking sector persists. The People's Bank of China controls interest rates for different kinds of deposits, state-owned banks still benefit considerably from their established branch network, and the state commercial banks are still the central provider of financial control. The Chinese government has implemented only partial reform of the commercial banking sector. Recent reforms show a surprising degree of inconsistency. For example, the Commercial Bank Law (effective in 1995) guarantees the formal-legal independence of commercial banks, but the law still emphasizes that loan decisions should be taken under the "guidance of state economic policies" (art. 34). Abundant evidence confirms that China's commercial banks are not independent in their loan decisions (Zhu 1999; Leung and Mok 2000; Lin 2001). Political intervention is still rife despite legal reform of banking to foster formal autonomy in lending decisions. In 2003, private firms and individuals received only about 1 percent of short-term loans of China's state commercial banks, including the four state commercial banks, policy banks, and agencies of postal savings (*China State Statistical Yearbook 2005*: 674). Even the newly founded joint-equity banks are not completely immune from political interventions (Wong 2000).

The importance of political capital for a firm's success in getting a bank loan can be readily inferred from Figure 4-5, which compares credit access across 18 cities for firms that do not receive government assistance (left-hand side) with those that do (right-hand side). Figure 4-6 shows that where the CEO is politically well-connected and active as party secretary, firms have greater success in securing bank loans.

That political ties play an essential role independently of the firm's ownership status is confirmed by Table 4-1. With only two exceptions (listed firms and collective firms with CEOs holding a party office), both government assistance and active party participation of CEOs are associated with greatly improved chances to secure a bank loan. Although bivariate relations are of course technically and methodically not appropriate to establish causal relationships, market transition theory and resource dependence theory both provide strong arguments supporting underlying causalities hinting at a strong interventionism of political capital in China's state-controlled financial market. Our findings are also consistent with an analysis by Li et al. (2005), of a sample of more than 3,000 private firms showing that political connections are helpful in obtaining bank loans and tend to reduce discrimination by state banks.

A closer look at the sectoral distribution of government assistance confirms that political ties are used instrumentally to steer scarce capital into

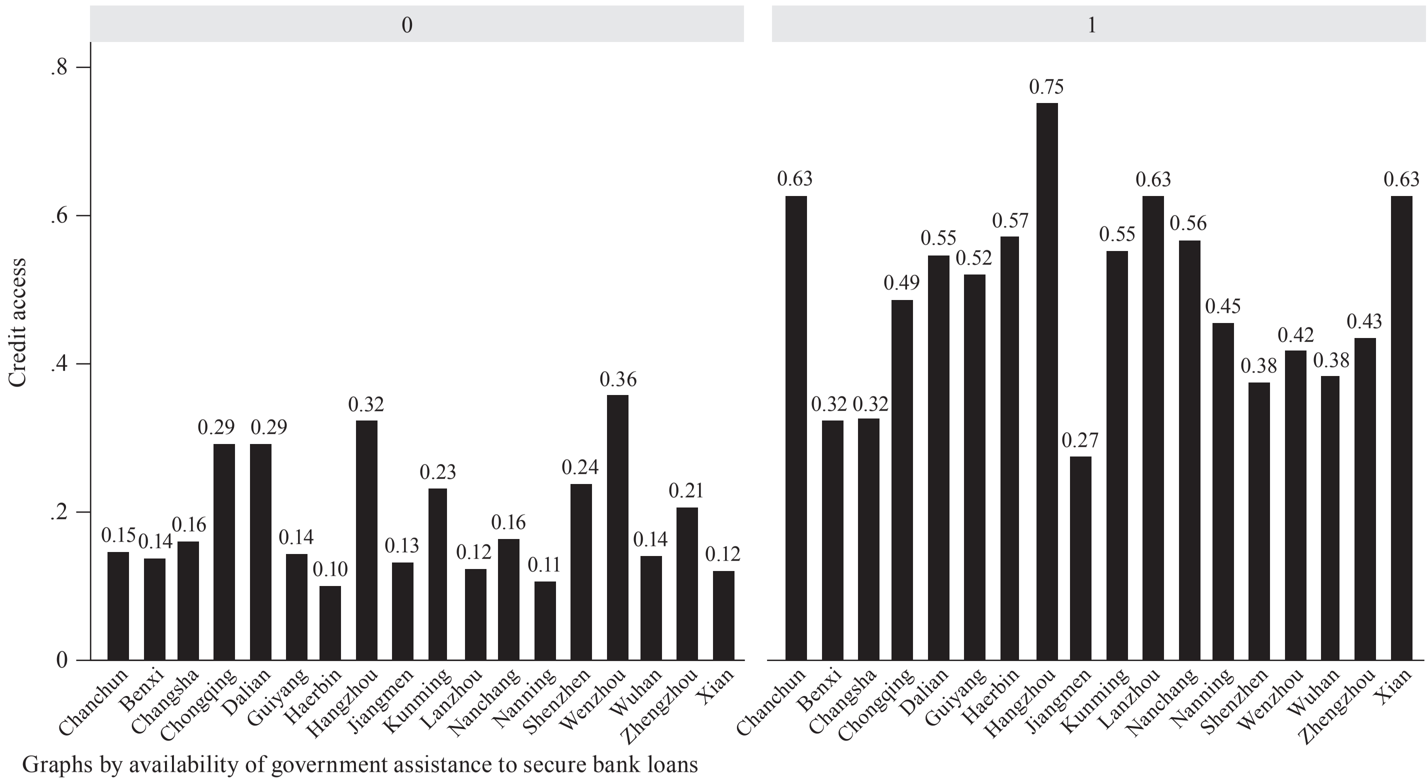

FIGURE 4-5 Effect of Government Assistance on Access to Bank Finance, 2003
SOURCE: Data from World Bank Investment Climate Survey, 2003.

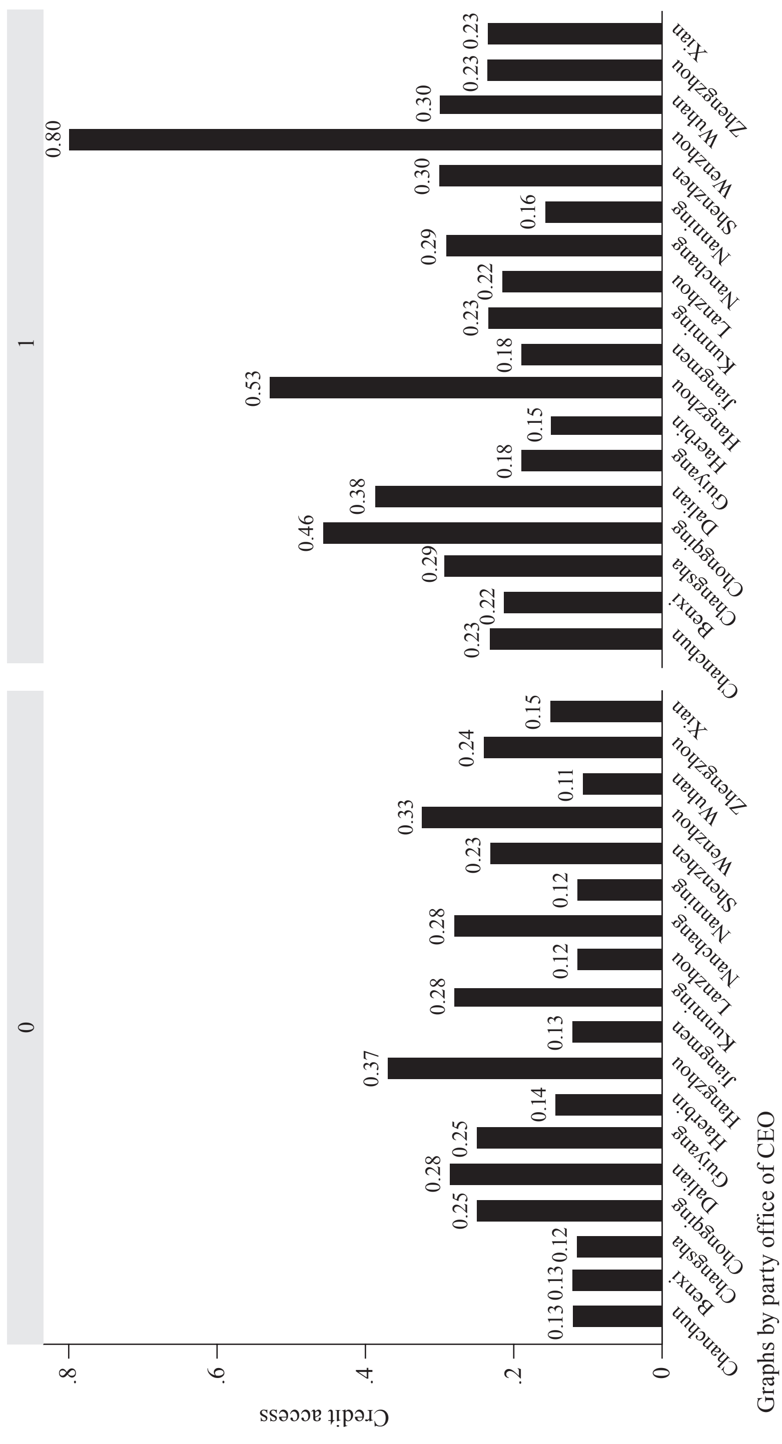

FIGURE 4-6 Effect of Politically Active CEOs on Access to Bank Finance, 2003

SOURCE: Data from World Bank Investment Climate Survey, 2003.

TABLE 4-1 Political Capital and credit access by ownership form

		SOE	*Collectively owned firm*	*Listed firm*	*Private firm*	*100% individual ownership firm*
Proportion of firms having a bank loan	Without government assistance	18.30%	12.29%	47.62%	15.33%	15.94%
	With government	44.32%	46.43%	62.96%	42.37%	42.24%
Proportion of firms having a bank loan	CEO without party office	15.97%	14.88%	66.66%	16.99%	16.72%
	CEO with party office	24.83%	14.02%	40.00%	32.17%	32.17%

SOURCE: World Bank Investment Climate Survey 2003.

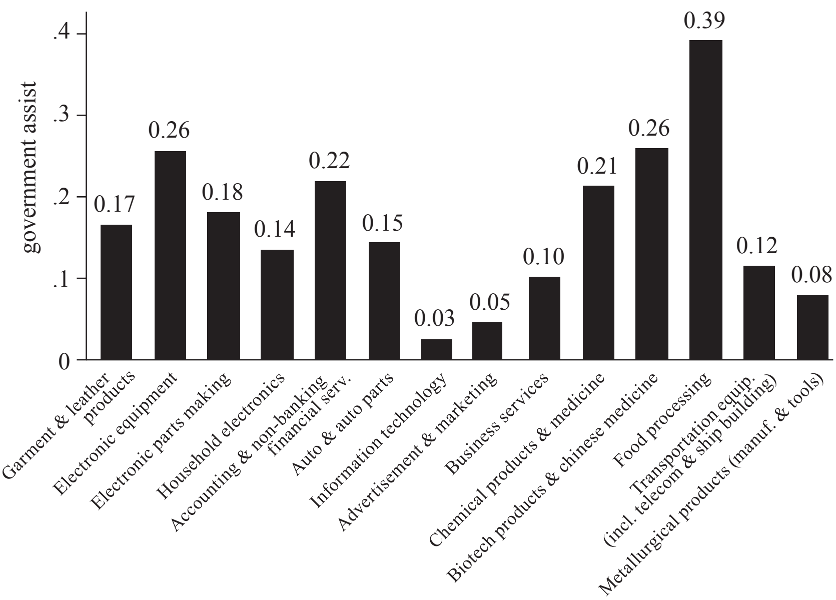

FIGURE 4-7 Sectoral Distribution of Government Assistance
SOURCE: World Bank Investment Climate Survey, 2003.

preferred industrial endeavors. Figure 4-7 provides evidence that government assistance in loan applications is particularly common in China's high-tech sectors such as biotechnology and electronics, which enjoy priority in China's current industrial policy and technology programs. In the high-technology

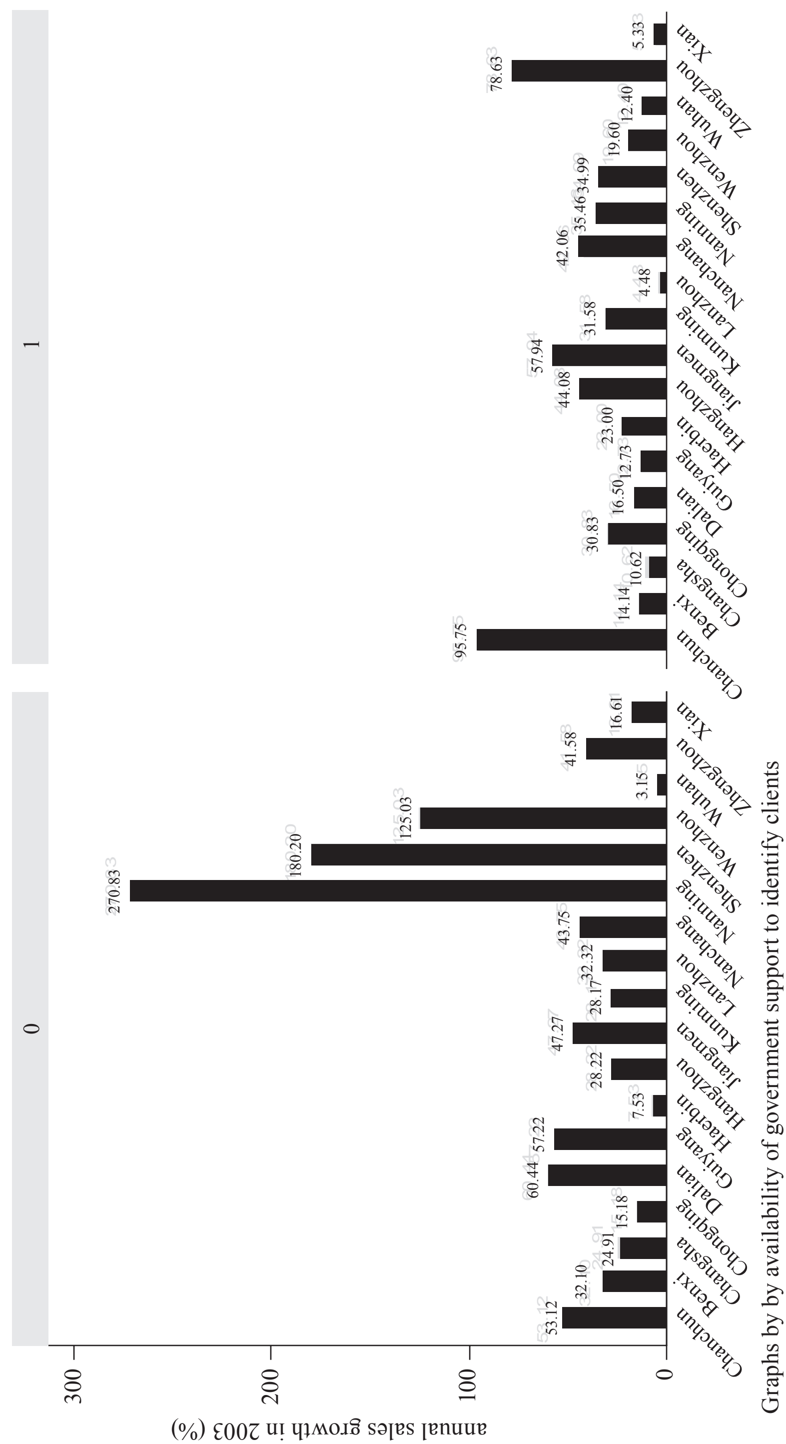

FIGURE 4-8 Government Assistance and Sales Performance

SOURCE: World Bank Investment Climate Survey, 2003.

sector, China's policy is similar to that of other Asian developmental states (Whitley 1999; Kang 2002).

Our analysis of the effect of political capital in product markets—our counterexample of a liberalized market—reveals a completely different picture. Figure 4-8 shows that political ties do not in general improve sales performance, as indicated in the comparison of firms without government assistance in securing clients (left-hand side) and those that enjoy government sponsorship (right-hand side). Only in Benxi and Xian does government assistance appear to be associated with slightly improved performance. In general, government assistance in securing either domestic or international clients does not affect the firm's sales growth. Specifically, as shown in Figure 4-9, political capital embodied in politically active CEOs does not result in stronger performance in the firm's sales.

Table 4-2 confirms our findings for most ownership forms. With the exception of collectively owned firms, political ties and government support are not linked to advantages on the product market. To the contrary, firms generally exhibit stronger growth in sales if they lack political ties in the form of government assistance and politically active CEOs.

Thus, it is clear that economic benefits generated by political capital depend crucially on the extent of market liberalization. Consistent with market transition theory (Nee 1989), positive payoffs of political capital are confined to regulated and state-controlled markets, whereas political capital does not yield any additional benefits in competitive markets. Our results match well with recent work by Li, Meng, and Zhang (2006), who analyzed determinants of party membership of entrepreneurs. Their findings show that the less developed the local market-supporting institutions and the less liberalized the local markets, the more likely entrepreneurs are to enter politics.

State Involvement in Firm Decisions

The implementation of the Company Law promulgated in 1994 has altered both the quality and intensity of state intervention in the firm, depriving the government of its former unchallenged monopoly rights and control over former state-owned enterprises [Ed: restore]. In the 1990s, state-crafted institutional change established the framework for converting them into public corporations. The objective was to transform loss-making state enterprises into profit-making firms through corporatization and listing on stock exchanges. With the Company Law, the government sought to bring organizational standards in line with Western-style corporate governance (Guthrie

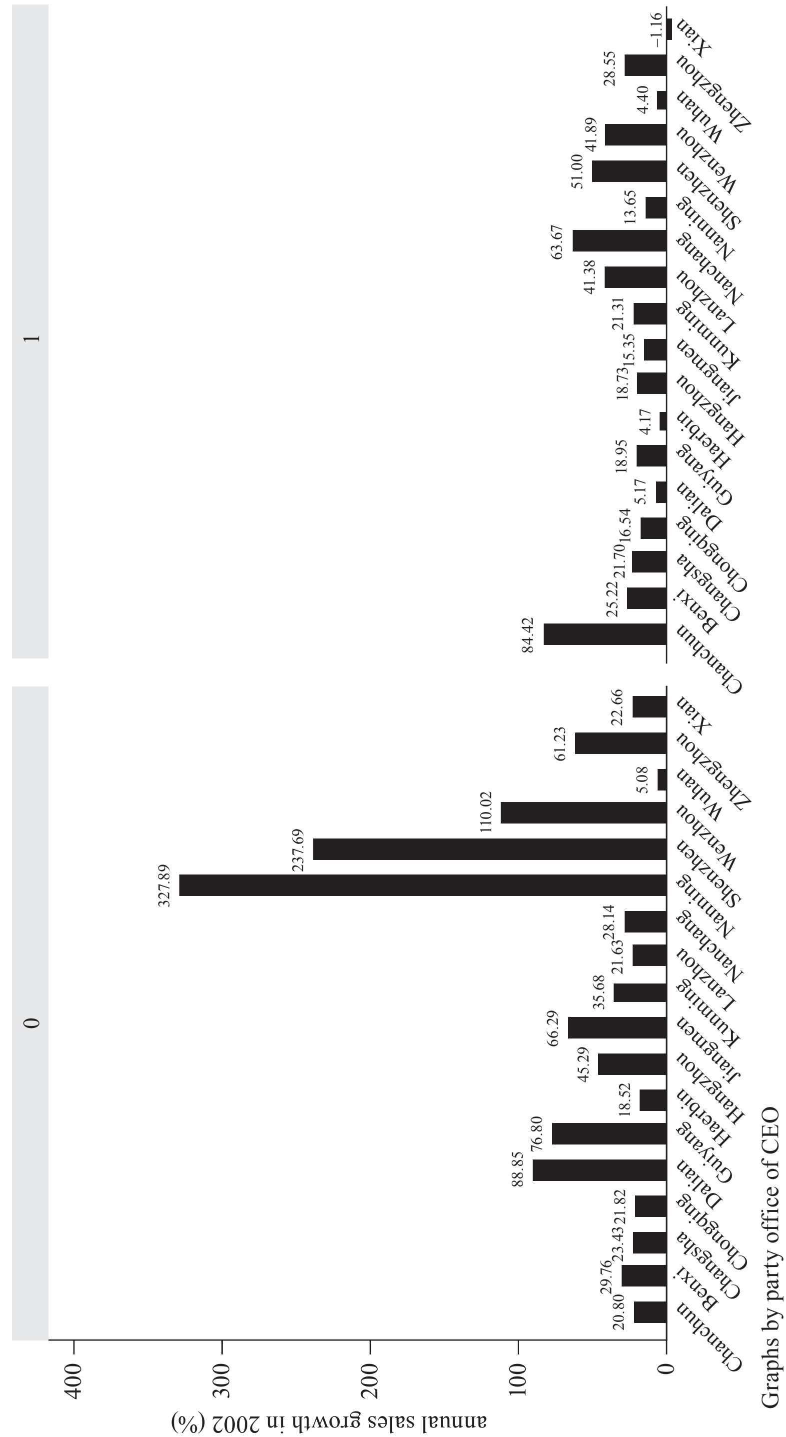

FIGURE 4-9 Politically Active CEOs and Sales Performance

SOURCE: World Bank Investment Climate Survey, 2003.

TABLE 4-2 Political Capital and Sales Growth by Ownership Form

		SOE	*Collectively owned firm*	*Listed firm*	*Private firm*	*100% individual ownership firm*
Sales growth in %	Without government assistance	27.35%	23.08%	30.09%	76.85%	97.06%
	With government	23.21%	38.17%	33.33%	27.66%	30.43%
Sales growth in %	CEO without party office	39.07%	20.25%	50.42%	75.54%	99.89%
	CEO with party office	22.49%	29.73%	13.30%	23.21%	17.89%

SOURCE: World Bank Investment Climate Survey 2003.

1999), shifting power from the party and government to the board of directors and the CEO as major decision makers within the firm (Wong, Opper, and Hu 2004). State involvement in firm decision making, however, was not completely abolished. In an effort to not lose all control rights over China's industrial key sectors, specific aspects of established political governance structures were maintained. Not surprisingly, this provided politicians and bureaucrats with opportunities for direct intervention in the firm. The state is particularly interested in maintaining involvement in large-scale modern corporations, business groups, and conglomerates in core industries, either listed or unlisted. Certain giant former state-owned enterprises, such as China National Offshore Oil Corporation (CNOCC) listed on the Shanghai Stock Exchange, are regarded as crucial in leading China's bid as a global economic power. Whether as a private firm that has grown into a major player in its niche or as a former state-owned enterprise, the larger the enterprise, the more the state becomes interested in guiding its future development. Two major channels for direct interference can be identified: state ownership of shares and governance structures within the firm.

State Intervention via the Ownership Channel

Although China has witnessed a major privatization move, reducing the size of the state sector by over 70 percent between 1996 and 2004, the government has often retained partial control rights in large-scale firms. Corporatization and stock exchange listing have reduced the average state shareholding in firms listed on the Shanghai Stock Exchange to about one-third of the firms' total shares. However, another third is held by corporatized state-owned companies.

Thus, on average, 60 percent of company shares are still under either direct or indirect state influence.

Bureaucrats maintain direct ties to such firms through their participation as members of the board of directors representing state-owned shares. As such, they are entitled to represent the state's interests in the firm's strategic decisions, albeit within the framework of an advisory capacity as stipulated by the rules of corporate governance of the Company Law (Gensler and Yang 1995). Thus, while the firm's top executive, the CEO, has full control over its management, the state has a voice—the more so the larger its ownership share in the firm—and votes on strategic decisions.

Such state participation in corporate governance, however, turns out to be problematic. State asset administration is carried out by an institution that serves as a representative of the central government. These so-called state asset management companies usually have weak incentives to perform monitoring activities. First of all, their officials usually do not receive any personal benefits from effective monitoring. Second, state shareholders do not operate under hard budget constraints; even if budgets are admittedly hardened, state shareholders can almost be sure to be bailed out by the state treasury if companies suffer financial distress. Not surprisingly, corporate performance of China's listed companies is negatively related to the proportion of a company's state shares (Xu and Wang 1999; Qi, Wu, and Hua 2000).

Government ownership of course also invites intervention in corporate governance beyond the regular board meetings and shareholder meetings. The continuation of close firm-business relations and informal networks among actors allow for ready interference in almost all types of firm decisions. Government involvement in corporate governance of firms listed on the Shanghai Stock Exchange is particularly pronounced when it comes to decisions affecting financial issues, that is, decisions on mergers, change in shareholding structure, and on share placements and new issues. Overall performance effects of this direct government intervention are negative, however, showing the state's inability to overcome the inherent incentive and information problems of state ownership even after a shift toward greater reliance on market mechanisms (Nee, Opper, and Wong 2006).

State Intervention Through Politicized Governance Structures

State involvement is further exacerbated through the persistence of politicized vertical command structures within the firm. Although the official policy line was to encourage a complete separation of government and business functions (*zhengqi fenkai*) to support a rationalization of the economic sphere,[7] the reforms in actuality revealed a high degree of ambivalence and inconsistency. In spite of the official propaganda, which claims to constrain the state's role to that of a normal shareholder without any priority rights to interfere into the firm's organization and governance, China's new company legislation reveals a more ambivalent position toward depoliticizing the former state-owned enterprise.

To begin with, Article 14, Company Law, still calls for a supervision of enterprises by the government and social masses. Inevitably, this claim may create conflicts with the intended enterprise independence. Even more serious deficits of the official depoliticization strategy result from the continuing influence of the "three old political committees"—party committee, labor committee, and trade union—placed within the firm. Despite the creation of new organizational and governance structures, such as shareholders' meeting, board of directors, and supervisory committee alongside the position of the CEO, the old political organs were not abolished. Instead, the Company Law guarantees and regulates their future involvement and responsibilities. Although the "old three" lost a large amount of their inherited coordination and control rights, their survival invites a continuation of political involvement in the firm's decisions. Particularly their long tradition as central political bodies within the firm provides fertile grounds for continuing informal involvement (Wu and Du 1998:68). Figure 4-10 sketches the internal structure and persisting links between the three old committees [*lao san hui,* i.e., party committees, trade union, and workers congress] and new decision-making bodies [board of directors, manager, and board of supervisors].

Article 17 of the Company Law specifies "the activities of the local branch units of the CCP in a company shall be carried out in accordance with the Constitution of the CCP," but this constitution provides little additional clarification of the party's scope of involvement. It simply delegates the implementation of higher party decisions to local party committees and grants them the right to "supervise party cadres and any other personnel." More specific was former General Secretary Jiang Zemin's detailed sketch of the party's activities at the enterprise level. According to his guidelines, the party should focus on four functions: (1) implementation of the party line, (2) fulfillment of party-related tasks with special attention to production and management, (3) participation in the most important business decisions, and (4) support for

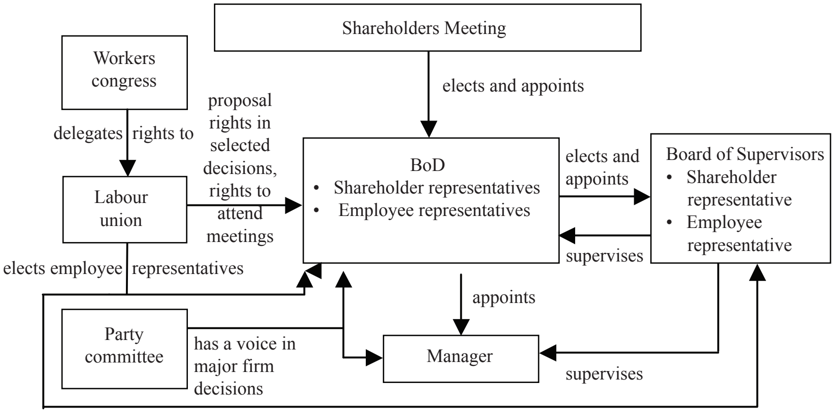

FIGURE 4-10 Corporate Governance of China's Listed Firms (According to Company Law)
SOURCE: Opper (2004).

the board of directors, the supervisory committee, and management (Foreign Broadcasting Information Service 1999).

Survey evidence confirms the active role of party committees. An in-depth study of state involvement in listed corporations finds persisting party interference in almost all domains of the firm's activity, with party committees exercising an even stronger influence in the firm than government bureaus (Nee, Opper and Wong 2007). Local party committees exert the most control in personnel decisions, especially the selection of managers of departments, branches, and subsidiaries, and the selection and dismissal of vice chief executive officers. In essence, party involvement concentrates on personnel issues, which have been a central focus of the *nomenklatura* system for decades of socialist planning (Shirk 1992:61). The fact that local party units tend to have a high level of involvement in decisions assigned de jure to the enterprise manager suggests that they may use the manager's office as their venue for interventionist activities.

Party influence within the firm may be even stronger if the CEO is actively involved in the party and holds a party office. Particularly in large- and medium-size firms, management positions are often filled by politically active members of the CCP. The previously mentioned Investment Climate Survey of 2,400 firms found that more than 40 percent of CEOs concurrently hold party positions. Although politically active CEOs are naturally most common in state-owned enterprises (with more than 70 percent of CEOs holding a party position), political participation of management personnel is also widespread in non-state-owned firms. Fifty-seven percent of CEOs in the surveyed listed firms and 17 percent of CEOs in officially registered private firms held party offices. Recruitments of politically active CEOs are often motivated by an effort to gain information advantages and utilize political capital to mitigate resource constraints, that is, in access to credit markets and markets for land and construction permits.

Conflicts of interests arise easily, as the Company Law lacks mechanisms to align the party committee's interests with the firm's performance. The party committee has neither residual claims nor benefits from local tax revenues. Party members, moreover, are insufficiently insulated from patron-client ties and may easily be "captured" by interest groups or be tempted to maximize their own self-interests. In sum, the party committee presides over a political network in the firm that can be used to mobilize informal opposition to reform policies that threaten vested interests in the firm. Our own interviews revealed conflicts of interests over labor issues as well as in strategic decisions, such as investments beyond the borders of the local locality.

Party intervention in firm decisions can have negative effects on performance. Based on data from 66 listed firms at Shanghai Stock Exchange specifying the extent of party intervention in 63 distinct firm decisions overall, Nee, Opper and Wong (2007) found evidence for such negative effects (on "return on assets" and "return on equity") for party interference, particularly, in financial decisions. This contributes to explaining why SOEs are unable to compete effectively with private enterprise. Interventions by the state in listed firms in which the state is a major shareholder have a negative effect on the firms' economic performance at a time when they face increasing market competition from private enterprise.

Conclusion

Our analysis has sought to highlight the structural and organizational features of politicized capitalism as a hybrid institutional order. The focal question is whether China's politicized capitalism is a new type of capitalism that will endure and complement the landscape of capitalist systems. The construction of politicized capitalism by means of ad hoc improvisations responding to the demands of rapid market-driven economic growth is a source of institutional continuity. Given the central role of the state at the outset of reform, path dependence alone would dictate a strong state component in the constitution of the new Chinese capitalism. After all, the same state that managed production and distribution under central planning guides the transition to capitalism.

The dilemma of state involvement in guiding economic life, is that, on the one hand, state intervention is associated with negative effects on the firm's performance when state bureaucrats directly influence decision making in the firm. On the other hand, in spite of negative performance effects, firms are not able to completely distance themselves from state actors as long as they depend on access to scarce resources controlled by the state in regulated markets such as the credit market or the market for land-use rights. Hence, politicized capitalism currently rests on lock-in effects in sectors where political and economic markets interact to blur the boundaries between the state and the firm. Large-scale, capital intensive firms dependent on state-controlled resources and firms in sectors characterized by a high dependence on government contracts such as the construction and the real estate business have strong economic reasons to accept and cultivate close state-firm relations. Moreover, partial state ownership in recently privatized state-owned enterprises provides ample opportunities for direct state intervention in corporate governance. If politicized capitalism persists in Nash-like equilibrium, then the structural and organizational interpenetration of political and economic markets will remain as incorrigible features of Chinese capitalism.

Notwithstanding lock-in effects of path dependence, politicized capitalism as a hybrid order itself embodies organizational dynamics of market transition. As evident from the contrast in utility of political capital in product and credit markets, the benefits from close state-firm relations mainly stem from the governments' ability to provide access to scarce resources and on state-owned enterprise. We infer from this that politicized capitalism is to an extent largely bounded within the state regulated and controlled sectors and constrained by the extent and size of the market economy. Small- and medium-scale firms, for example, operating in close-knit local business networks and in competitive markets are often able to distance themselves from the state in securing financial capital. It is estimated that about 30–50 percent of China's total capital investment is allocated outside the banking system (Tsai 2002). Friends, families, private founders and even business partners establish a reliable lending network that provides mutual loan opportunities. Several of our interviewees pointed out that they prefer private lending to bank lending as an efficient and flexible way of getting short-term capital. Moreover, a deepening market transition is under way, partly enforced by commitments to liberalization specified in China's World Trade Organization accession contract. In addition to the growing share of domestic nonstate financial institutions, increasing competition by foreign financial institutions will help to liberalize China's credit market, though progress is expected to be slow and gradual due to the extended branch networks China's state-owned banks can rely on. Hence even in the banking sector, currently the most regulated sector, the trend is clearly in the direction of liberalization.

Overall, we show that China's politicized capitalism is still in dynamic transition. Fiscal decentralization and the continued rapid growth of the industrial output contributed by the private enterprise sector encourage interest in shifting to the custodial and midwife roles characteristic of mature East Asian developmental states (Johnson 1982; Amsden 1989; Wade 1990; Evans 1995). Following the privatization of small- and middle-sized state-owned enterprises in the early 2000s, local governments are less involved in influencing economic decisions within the firm as they attempt to improve the business environment to attract entrepreneurs and investments to their region. It is not too far of a stretch to imagine that reformers might eventually want to include in their ambitious reform agenda a national commitment to constructing a modern polity wherein open electoral politics moves China beyond an outdated Communist Party dictatorship. It would take such a reform for China to move decisively beyond politicized capitalism to emerge as a mature East Asian developmental state, where the state and its bureaucrats operate within the framework of an independent legal system, which guarantees clear and distinct state-firm boundaries where private actors are shielded against arbitrary state interference.

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Notes to Chapter Four

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1. Respondents are asked to assess whether the bureaucracy hinders business activities.

2. The first industrial policy guideline was the "*Guowuyuan guanyu dangqian chanye zhengce yaodian de jueding,*" released by the State Council on March 15, 1989.

3. The so-called Spark program (since 1986) supports rural development; Program 863 (since 1986) currently emphasizes education in the fields of automatization, computer-aided design, and computer integrated manufacturing systems—technologies, medical apparatus, biotechnology, and material sciences; the Torch Program (since 1988) focuses on the provision of research infrastructure; and the Key Technologies R&D Program provides support for R&D in key industrial sectors.

4. Interview conducted November 11, 2005, in the Yangzi Delta.

5. Interview conducted on November 11, 2005, with the founder of a firm producing building material in the Yangzi Delta.

6. Interview conducted with a supplier of construction material on November 1, 2005, in the Yangzi Delta.

7. This context was mentioned in "*Gufenzhi qiye shidian banfa*" (05/15/1992), Chapter 1, line 1, in *Zhongguo Renmin Daxue Jinrong yu Zhengquan Yanjiusuo* (Eds.), 2000. A statement by Wang Zhongyu, Secretary General of the State Council, further details: "The first (aim) is to accelerate the separation of government functions from enterprise management, make further efforts to change government functions, reform the relationship of administrative subordination between the government and enterprises, comprehensively realize the decision-making power of enterprises, relieve the competent government departments of their relationship of administrative subordination with the economic entities run by them or the enterprise directly managed by them, and thoroughly cut their ties in terms of manpower and financial resources" (Xinhua, February 3, 2001). In this spirit, the tenth 5-year plan specifies, "to complete the establishment of a modern enterprise system under which there will be clearly established ownership, well defined power and responsibility, a separation of enterprise management from government administration, and scientific management" (Xinhua, March 17, 2001).