Perspectives on the Development of the Private Business Sector in China

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RESEARCH

Perspectives on the Development of the Private Business Sector in China

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This article reviews new literature on the development of China's private sector. Since this sector's development is embedded in and characterised by a wider institutional environment, several general characteristics of China's capitalist transformation are discussed. Insights drawn from political science help in the understanding of the strategy of "wearing a red hat" and the emergence of China's private sector. The closely interwoven relationships between private companies and the Party-state that have taken place since the 1990s are also examined. The review indicates that focusing on state/capital relationships at different administrational levels contributes to a better understanding of China's private sector. The main conclusion is that although the development of the new private enterprises enabled the ruling elite to form and consolidate a hegemonic project that provided relative societal coherence, the project's continuity is threatened by a tendency for crises to occur.

Since the 1980s, an impressive private sector has emerged in China. It seems as if a legitimised private sector now prevails where once different forms of state enterprises dominated. Overall, there has been a clear increase in companies that are formally run as private businesses: in 1978, SOEs (state-owned and state-controlled enterprises) accounted for 77.6 per cent of industrial output, whereas in 2006 the share was down to 31.2 per cent, while the share of private companies had risen to 37.2 per cent. The share of foreign-funded private enterprises, including investment from Hong Kong, Macau and Taiwan, amounted to 31.6 per cent. Thus, the private economy, understood in a very broad sense as comprising collectively-owned enterprises (COEs),[1] individual and other private enterprises, accounted for 65 per cent of gross domestic product.[2]

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[1] COEs at the subnational level often represent enterprises owned by cities, urban districts and communities that have been wholly or partially privatised in recent years. As will be seen in the following, formal legal differentiation between company forms in Mainland China is difficult. This is due to, among other things, the peculiar structure of Chinese capitalism, the blurred dividing line between public and private property, and the corresponding spread of inaccurate expressions such as "non-state" or "popularly managed" companies.

[2] National Bureau of Statistics, *Statistical Yearbook of China 2009*, at <http://www.stats.gov.cn/tjsj/ndsj/2009/indexch.htm> [25 July 2011]; Chen Jiagiu and Wang Qin, "The Reform, Opening, and Development of China's Industrial Economy", in *Transforming the Chinese Economy*, ed. Fang Cai (Leiden: Brill, 2010), pp. 39–83. As a matter of fact, different calculations lead to different results. Compare with, for instance, Huang Yasheng, *Capitalism with Chinese Characteristics: Entrepreneurship and the State* (New York: Cambridge University Press, 2008), pp. 13–9, whose figures show that the sum of indigenous and foreign private firms amounted to only 50.8 per cent of industrial output in 2005.

How did this transformation take place? What shaped the evolution of the new private business sector? To answer these questions, the author reviews several perspectives that focus on wider institutional environments and social contexts. An accurate analysis of the corporate sector cannot be confined to the conventional unit of analysis, the firm. As firms both instigate and absorb institutional change, theoretical approaches need to be widened to reflect the importance of business relations in the form of coordination and ties with non-economic institutions. While there is now widespread acknowledgment that the institutional environment conditions the economic field, many endeavours to identify these institutions neglect the "non-market" relations that may be important as explanatory variables. It is important to highlight the importance of the practices of entrepreneurs in the creation of new businesses, but such practices go well beyond "managerialist" assumptions in neoclassical economics as well as "voluntaristic" theories in sociology and political science.[3]

Three perspectives inform the author's review. First, by making reference to comparative political economy, the author illustrates that an appreciation of the general characteristics of the contemporary Chinese system — perceived as a distinct form of state-led capitalism — helps to understand and classify the specificity of gradual institutional change in the enterprise sector. Second, the author draws on insights from new approaches in political science for the analysis of gradual institutional change, introducing the empirical phenomenon of "wearing a red hat" — a phrase that refers to the practice of informal privatisation that shaped the emerging private sector from the 1980s onwards — and the closely interwoven relationships between private companies and the Party-state since then. Third, the author shows that focusing on the state/capital relationships at different administrational levels contribute to a more precise picture of the design of China's private sector.[4] Thus, this review shows that a flourishing private sector was not just induced by flexible informal institutions from below — by managerial agency creatively dealing with constraints as told in liberal marketisation success stories.[5]

The author begins by discussing some essential spheres of China's new capitalism and introduces several tools for understanding gradual institutional change within the private business sector. In the subsequent sections, the author shows how the strategy of "wearing a red hat" and the phenomenon of thickly embedded capitalism is

[3] Walter W. Powell and Paul J. DiMaggio, eds., *The New Institutionalism in Organizational Analysis* (Chicago, IL: The University of Chicago Press, 1991).

[4] By challenging theories of market transition which argue that the "transition from redistributive to market coordination shifts sources of power and privilege to favour direct producers relative to redistributors" (Victor Nee, "A Theory of Market Transition", *American Sociological Review* 54 [1989]: 663), this article does not overlook the numerous possibilities for "redistributive power" to capture market opportunities (see Iván Szelényi and Erie Kostello, "The Market Transition Debate: Toward a Synthesis?", *American Journal of Sociology* 101 [1996]: 1082–96).

[5] Huang, *Capitalism with Chinese Characteristics: Entrepreneurship and the State*.

understood in recent literature. The closely interwoven relationships between private companies and the Party-state that have taken place since the 1990s are also examined. To gain a wider view, the author then outlines perspectives that analyse the corporate sector against the background of multi-level governance, state entrepreneurialism, private-public networks and the capacity of the central state to steer and reform. The review concludes that although the development of the new private enterprises enabled the ruling elite to form and consolidate a hegemonic project that provided relative societal coherence on the often bumpy road to reform, the project's continuity faces the possible occurrence of crises.

CHINA'S CAPITALIST TRANSFORMATION

To avoid reducing significant institutional change to either the achievements of individuals or the shrewdness of entrepreneurs, one has to give due weight to the broader changes in the Chinese society that have led to a form of "Chinese" capitalism.

In this respect, it is necessary to focus on the social and political embeddedness of the market. The term "embeddedness" originates from a lengthy discussion that started from Polanyi, and grapples with the relationship between "economy" and "society". Accordingly, the economy is not autonomous and economic relations do not exist in an abstract idealised market as understood by economic theory, but are subordinated to politics and to a wider set of social relations, e.g., trust and cohesion.[6]

The Chinese system has undergone an unprecedented transformation from a planned economy to a strong market-oriented system while exhibiting a degree of continuity in its political and social institutions.[7] Although the Chinese model will have vestiges of a bureaucratic planned economy and a ruling Communist Party for a long time to come, it cannot be equated with a simple hybrid that combines "capitalist" and "socialist" principles. That would only be possible if one defined these terms quite narrowly and viewed socialism like the current Chinese leadership does as pursuing economic growth by any means deemed necessary, and capitalism as a mere synonym for markets.

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[6] Jens Beckert, "The Social Order of Markets", *Theory and Society* 38 (2009): 245–69; Neil Fligstein, *The Architecture of Markets* (Princeton, NJ: Princeton University Press, 2001); Mark Granovetter, "The Economic Sociology of Firms and Entrepreneurs", in *New Developments in Economic Sociology*, ed. Richard Swedberg (Cheltenham: Edward Elgar, 2005), pp. 160–97.

[7] John McMillan and Barry Naughton, "Elements of Economic Transition", in *Reforming Asian Socialism: The Growth of Market Institutions*, ed. John McMillan and Barry Naughton (Ann Arbor, MI: University of Michigan Press, 1996), pp. 3–15; Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge, MA: MIT Press, 2007); Kellee S. Tsai, *Capitalism without Democracy: The Private Sector in Contemporary China* (Ithaca, NY: Cornell University Press, 2007).

State-led capitalist developmentalism thus more accurately captures the economic dynamics in China.[8] A market-liberal entrepreneurial spirit coexists with widespread state interventionism, which in turn is guided by macroeconomic success parameters manifested in a heterogeneous bundle of private-public economic regimes.

Among the features of China's capitalist transformation that are relevant for the purpose of this review, the following stand out.

First, the State acts as a main initiator of economic restructuring. Because the Chinese political system is constituted by a notable combination of central and decentralised power, this competition-driven form of multi-level governance will be dealt with in more detail below. It is a key factor in capturing the dynamics of company reorganisation since it has also brought about relative social stability and thus made possible many of the significant transformations in the first place.[9]

A second characteristic is the special forms of competition and private-public corporate organisation. The accumulation drive in China is being achieved in an environment where economic rights of disposition and control shift from state

[8] The author refers here to insights of *Comparative Political Economy* (see Bruno Amable, *The Diversity of Modern Capitalism* [Oxford: Oxford University Press, 2003]); David Coates, *Models of Capitalism: Growth and Stagnation in the Modern Era* (Cambridge: Polity Press, 2000); Bob Jessop and Sum Ngai-Ling, *Beyond the Regulation Approach: Putting Capitalist Economies in their Place* (Cheltenham: Edward Elgar Publishing, 2006); Wolfgang Streeck, *Re-Forming Capitalism: Institutional Change in the German Political Economy* (Oxford: Oxford University Press, 2009); Wolfgang Streeck, "E Pluribus Unum? Varieties and Commonalities of Capitalism", MPIfG Discussion Paper 10/12, Max Planck Institute for the Study of Societies, Cologne, 2010. See <http://www.mpifg.de/pu/mpifg_dp/dp10-12.pdf> [25 July 2011]; Tobias ten Brink, *Geopolitik: Geschichte und Gegenwart kapitalistischer Staatenkonkurrenz* (Münster: Westfälisches Dampfboot, 2008); Tobias ten Brink, "Strukturmerkmale des chinesischen Kapitalismus", MPIfG Discussion Paper 10/1, Max Planck Institute for the Study of Societies, Cologne, 2010. See <http://www.mpifg.de/pu/mpifg_dp/dp10-1.pdf> [25 July 2011]. To examine the corporate sector, the historical variability of capitalist systems is taken into account. In recent years, more and more China scholars have begun to study China as a new form of state-led capitalism (see Christopher A. McNally, ed., *China's Emergent Political Economy: Capitalism in the Dragons's Lair* [London: Routledge, 2008]; Victor Nee and Sonja Opper, "On Politicized Capitalism", in *On Capitalism*, ed. Victor Nee and Richard Swedberg [Stanford, CA: Stanford University Press, 2007], pp. 93–127; Gordon Redding and Michael A. Witt, *The Future of Chinese Capitalism: Choices and Chances* [Oxford: Oxford University Press, 2007]; Tobias ten Brink, "Strukturmerkmale des chinesischen Kapitalismus").

[9] In capitalist systems, the interactions between economic and political actors can form a network characterised by structural interdependencies. Government actions play a constitutive role in shaping economic processes. In reality, the crisscross of areas of government responsibility and its underlying institutional characteristics is the basis for distinct political systems — such as liberal states or, in the case of China, the "Party-state". In order to be able to distinguish between political systems, varying degrees and forms of state intervention and business promotion must be taken into account. State intervention and state ownership need not exclude capitalist ownership but can be among the many forms of particularistic control and the exercising of economic and political power, e.g., in the form of state capital.

authorities to the management of numerous companies.[10] This process reconfigures the structurally interdependent relations between economic actors and those with political power. These relationships are generally governed by a "mixed economy" system of formal and informal relations that is neither "free" nor "competitive" in the classic sense. Although a renewed form of state enterprise is dominant at the level of the central government, private-public economic regimes have gained particular significance at the subnational level. As shown in the following, the predominant practice of informal privatisation ("wearing a red hat") began to include formal privatisation from the 1990s — without overriding the symbiotic ties between Party, State and industry.[11]

Third, the Chinese integration into global, East Asian and other transnational economic relations represents another feature that requires attention. The People's Republic of China developed its economy in a phase of advanced transnationalisation that coincided with changing global economic and geopolitical structures and contributed to a significant opening-up of the economy. The relative success of company reorganisation in China is thus partly due to favourable external opportunity structures — China became the world's most attractive production location at the precise moment when real accumulation in the old centres was slowing down after the 1970s and a new international division of labour was emerging.[12] The geopolitical landscape had also changed, i.e., improved relations with the United States, that worked in China's favour. Furthermore, the almost global expansion of market relations from the 1970s onwards, accompanied by the belief in dynamic markets, the role of individual entrepreneurialism, new administrative structures and liberal concepts of corporate governance greatly encouraged Mainland China to create a private sector.[13]

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[10] Victor Nee, "Organizational Dynamics of Institutional Change: Politicized Capitalism in China", in *The Economic Sociology of Capitalism*, ed. Victor Nee and Richard Swedberg (Princeton, NJ: Princeton University Press, 2005), pp. 53–74.

[11] The emergence in urban labour relations of a fragmented type of labour-exclusive corporatism would be another central feature of China's capitalist transformation but cannot be considered here. The various types of production regimes, a massive segmentation and flexibilisation of employment, low base wages, long working hours that are often in violation of existing legal standards and also huge wage differentials between employees, and the lack of trade union mobilisation capacity opened an expanse of opportunities for (but were also the result of) private entrepreneurial "experiments".

[12] Shaun Breslin, *China and the Global Political Economy* (Basingstoke: Palgrave Macmillan, 2007); Hung Ho-fung, ed., *China and the Transformation of Global Capitalism* (Baltimore, MD: The Johns Hopkins University Press, 2009).

[13] In the 1980s and 1990s, a huge number of China's international investment projects served the aim of informally transferring property from state to private ownership (see Ding Xueliang, "Informal Privatization through Internationalization: The Rise of Nomenklatura Capitalism in China's Offshore Businesses", *British Journal of Political Science* 30 [2000]: 121–46). This then represents another strategy for transforming the economy that cannot be taken into consideration here. These informal privatisations involved several forms of changing the *de facto* ownership of public assets, e.g., illegally shifting abroad money gained in China or siphoning funds from state-owned firms. It was conducted almost exclusively by cadres and managers (and their kin) in positions of advantage because they had the key resources for this form of marketisation, i.e., permission to work abroad and invest capital.

In China, institutional change did not lead to the radical replacement of one institutional arrangement with another, but to new combinations and layering that brought about significant processes of institutional conversion. Thus, the development of the PRC did not lead to the adaptation of a liberal model of capitalism but gave birth to a novel form of competition-driven, state-led capitalism.[14] In what follows, one must bear this constellation in mind as it gave the evolution of the private sector its unique form.

THEORISING INSTITUTIONAL CHANGE

How can we explain the significant historical changes in the Chinese economy and especially the ascent of a huge private sector? The following sections will show how experimentation *from below*, i.e., "wearing a red hat" (*dai hong maozi*), whereby private companies mask their private ownership by registering as publicly-owned companies, interact both with growth-oriented policies, at times crisis-induced,[15] and political steering *from above* (e.g., the role of the State, the transformation of COEs and SOEs, new regulatory institutions), and produce a distinct business sector.

To understand the gradual transition within the economic system, new political science tools for analysing institutions may aid research on China. These tools portray institutional development in an evolutionary manner, but emphasise its potentially discontinuous effects. The application of tools in China's case may yield some interesting results (e.g., about the evolution of new markets) even for non-China specialists.[16]

From a historical institutionalist perspective, institutions are described as "social regimes" or as ruling groups (Herrschaftsverbände) in the Weberian sense in order to capture their provisional, adaptable and hence contestable nature.[17] Institutional change derives from interactions among various actors. Thus, institutions are persistently contested and are often infused with ambiguities that can be exploited as sources and levers for change.

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[14] As is pointed out, this state-led or "political" form of capitalism bears traces of its past: "Political capitalism is capitalism in the sense that it is oriented towards the rational acquisition of profits, but it is political because this happens under the tutelage of the state and/or in conditions of systematic political interference in the economic system. There are many reasons why managers who have become owners might feel more comfortable navigating a Weberian world of political capitalism rather than a world governed by the conditions of *laissez-faire* competition. As former socialist and post-communist managers, they know the rules of the game in a system in which economics and politics are interconnected" (Gil Eyal, Iván Szelényi and Eleanor Townsley, *Making Capitalism without Capitalists: Class Formation and Elite Struggles in Post-Communist Central Europe* [London and New York: Verso, 2000], p. 172).

[15] In attempting to understand institutional change, the random outcomes of uncertainties and crises require special attention. The history of reform should thus be read as the effects from a sustained crises-laden process of restructuring.

[16] See, for instance, Fligstein, *The Architecture of Markets*, p. 14, in which Fligstein complains that the evolution of new markets has been insufficiently considered in the social sciences.

[17] Wolfgang Streeck and Kathleen Thelen, "Introduction: Institutional Change in Advanced Political Economies", in *Beyond Continuity: Institutional Change in Advanced Political Economies*, ed. Wolfgang Streeck and Kathleen Thelen (Oxford: Oxford University Press, 2005), pp. 1–39.

To avoid a formalistic analysis of institutions in capitalist systems, we must look at the distribution of power in society — both in the past, which led to the formation of institutions, and at present, which is altering the appearance of institutions. This is necessary to see "behind" the formal structure of institutions and grasp the coalitions of actors that shape them. "The foundation [of a dynamic analysis] is one that conceives institutions above all else as distributional instruments laden with power implications".[18] The creation of new institutions requires "institutional work" by a wide range of actors.[19] In the case of China, this includes both those with the capacities and skills to act as businessmen and those with a supportive role to the entrepreneur's endeavours.

Streeck/Thelen conceptualise several ideal-typical mechanisms that capture the gradual transition of institutions in developed political economies that, over time, can cumulate into major institutional transformations.[20] In the case of China, two mechanisms are particularly relevant: institutional *layering* and institutional *conversion*. Institutional layering describes processes leading to the often initially informal formation of institutions that are in parallel and in interaction with the existing institutions. These processes ultimately bring about changes that have a transforming effect on the existing institutions. To a certain extent, groups of actors with insufficient power are able to modify institutions in an oblique way. "Layering involves active sponsorship of amendments, additions, or revisions to an existing set of institutions".[21]

An institutional conversion represents the use of the existing institutions for new or alternative purposes. These processes can be set in motion by a shift in the environment that confronts actors with problems: "Different from layering and drift, here institutions are not so much amended or allowed to decay as they are redirected to new goals, functions, or purposes".[22] Even when the prescribed attributes of institutions remain in place, their substantive roles may change dramatically.[23]

Kellee Tsai was among the first to use these tools to reveal some understanding of the evolution of China's private sector.[24] Tsai explains that those ideal types of

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[18] James Mahoney and Kathleen Thelen, "A Theory of Gradual Institutional Change", in *Explaining Institutional Change: Ambiguity, Agency, and Power*, ed. James Mahoney and Kathleen Thelen (Cambridge: Cambridge University Press, 2010), pp. 1–37, 7–8.

[19] Thomas B. Lawrence and Roy Suddaby, "Institutions and Institutional Work", in *The Sage Handbook of Organization Studies*, ed. Stewart R. Clegg *et al.* (London: Sage, 2006), pp. 215–54.

[20] Streeck and Thelen, "Introduction: Institutional Change in Advanced Political Economies".

[21] Ibid., p. 24.

[22] Ibid., p. 26.

[23] Other modes of gradual but nevertheless potentially transformative change such as "displacement", "drift" and "exhaustion" cannot be considered here (see Streeck and Thelen, "Institutional Change in Advanced Political Economies", pp. 18–30).

[24] Kellee S. Tsai, "Capitalists without a Class: Political Diversity among Private Entrepreneurs in China", *Comparative Political Studies* 38 (2005): 1130–58; Kellee S. Tsai, "Adaptive Informal Institutions and Endogenous Institutional Change in China", *World Politics* 59 (2006): 116–41; Tsai, *Capitalism without Democracy: The Private Sector in Contemporary China*.

institutional transitions that to date have mainly served to analyse liberal democracies and OECD (Organisation for Economic Co-operation and Development) economies, can be applied to China: "The case of China demonstrates that even in non-democratic settings where formal institutions appear to be imposed in top-down fashion rather than subject to popular suffrage, everyday actors may quietly appropriate formal institutions to serve their own ends".[25] Tsai then describes the circumstances under which institutional change can in all probability be anticipated:

> This is most likely to occur when there is a gap between the original intentions of formal institutions and the perceived needs and interests of local actors. At the same time, local state agents may collaborate with ordinary people by intentionally misinterpreting the formal institutions that they are supposed to uphold. Such bureaucratic deviance is more likely to be found in situations (1) where different formal institutions have conflicting mandates (a situation that facilitates ignoring one set of rules in order to comply with another); (2) where policy implementation is relatively decentralised; and (3) where local officials have convergent interests with local citizens in a particular policy area (for example, promoting local economic growth, hiding revenues from higher levels of government, protecting local industry, bending rules to attract external investment, and so on). In turn, these collaborative interactions may generate adaptive informal institutions that provide a powerful demonstration effect and prompt policy elites to transform key attributes of the official political and economic orders.[26]

The following will show that China enjoyed an opportunity structure conducive to these circumstances.

THE STRATEGY OF "WEARING A RED HAT" AND THICKLY EMBEDDED CAPITALISTS

Research on China based on both the "red hat" strategy and the rise of private entrepreneurs with close ties to the State and other "red capitalists", illustrates how evolutionary change transformed the Chinese corporate sector. Specifically, it describes how innovative *informal* practices triggered the layering of formal institutions that eventually resulted in institutional conversions.

Reform can be seen to have taken place in two phases. To avoid the trap of analysing institutional change in China as a well-designed plan rather than one that is contingency-conditioned, one must keep three facts in mind.

First, the reform process was initiated for the survival of the Party-state, not for ideological principles and neither as a clear concept. This resulted in a process that was fought out in a "trial and error" mode. In line with theories of institutional change, complementarity of institutions did not exist *ex ante* in a functional-fit sense, but was discovered and developed *ex post*. Years of reform were at times jeopardised by both the pace of change, which differed from region to region, and by U-turns. For instance, the "Tiananmen" event led to a conservative rollback between 1989 and 1991 that was brought to an end by the Party's reform wing only in early 1992.

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[25] Tsai, "Adaptive Informal Institutions", p. 210.
[26] Ibid., p. 123.

Second, due weight needs to be given to historical continuities. These explain why the private sector frequently emerged in regions that already had a rich tradition of doing business and subsequently made way for several types of private sector organisations. Although this path-dependent nature of transformation, with regard to the pre-1949 *and* pre-1978 economic forms, did not entirely preclude actors from reshaping and diversifying through path-dependent learning, it nonetheless shaped the reform process in a myriad of ways.

Third, for a topic that receives less exposure, there was (and still is) enormous heterogeneity in the development of the private business sector.[27] At one extreme, a range of "Chinese localities have maintained a thriving private sector since the earliest years of reform (e.g., Wenzhou)".[28] Compared with other regions, Wenzhou began with only a few locally owned SOEs with the family acting as the entrepreneurial core for a plethora of firms to develop. In coastal cities such as Xiamen, which became a special economic zone, foreign-invested (private) enterprises drove economic growth. At the other extreme, some localities were burdened with a very strong state sector. Northeast China, especially Liaoning, a major industrial base prior to 1978, was slow in developing a private sector. The majority of localities lay between these poles: private firms grew from a hybrid mix of "corporatised", and later, privatised SOEs and COEs.[29]

The First Phase of Reform

Following the ruinous Cultural Revolution, the elite increasingly accepted as valid whatever policies that increased national output. This resulted in a combative process of "trial and error" which led to experimentations with markets and entrepreneurialism. Whilst the resilience of the Party-state prevented more radical transformation, this tentative constellation enabled adaptive informal institutions to play a vital role in the process of change. Two phases of gradual transformation can roughly be identified: the period from 1979 to 1989/1991 and the period from 1992 onwards. In the first phase, agriculture was the predominant sector in which the evolution of new markets began to take shape. The industrialised urban sectors followed a little later.

A reduction in the planned system was not immediately accompanied by a widening of decision-making powers for business managers. In this context, the "red hat" strategy represented an effective evasive manoeuvre. In the first phase of reform, it was the most popular practice whereby companies that were undeniably

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[27] Jean C. Oi, ed., *Going Private in China: The Politics of Corporate Restructuring and System Reform* (Stanford, CA: Walter H. Shorenstein Asia-Pacific Research Center Books, 2011).

[28] Tsai, "Capitalists without a Class: Political Diversity among Private Entrepreneurs in China", p. 1144; Jin Zeng and Kellee S. Tsai, "The Local Politics of Restructuring State-Owned Enterprises in China", in *Going Private in China*, ed. Oi, pp. 39–69.

[29] Christopher A. McNally and Chu Yin-Wah, "Exploring Capitalist Development in Greater China: A Synthesis", *Asian Perspective* 30 (2006): 31–64, 50.

private, were able to mask their private ownership by formally registering as COEs, which were basically state-owned enterprises under the control of local governments.

For a more precise analysis, Tsai distinguishes between formal and informal institutions.[30] Adaptive informal institutions are more likely to evolve in environments where both executors in formal institutions and creators of informal adaptations have converging interests. Formal institutions are transformed in a process whereby both state and non-state actors benefit from the existence of adaptive informal institutions that, in the process of transition from informality to formality, may gain intermediate levels of formality. Tsai backs up the argument with the example of how privately-run companies were established in the guise of collective enterprises. Prior to 1988, it was forbidden to operate private enterprises with more than eight employees. Registration as a COE was a way of founding larger private companies.

As shown, a process of institutionalisation through informal practice can be detected in the evolution of the private sector. In the first phase of reform, and even up to the mid-1990s, the lack of official recognition led many businessmen to enter into an arrangement with the local authority whereby the company would become publicly-owned and then subcontracted to them. "Estimates on privately owned collective enterprises range from one-third nationally to as high as 90 per cent in some localities".[31] Various terms were used to portray this substitute for a private firm: "pseudo-collectives", "pseudo-SOEs" or "disguised private enterprises", to name a few.[32] The strategy of "wearing a red hat" brought advantages including favourable tax treatment and preferential access to bank credit. Local officials provided the firms with money, markets, land and labour. It was not only rural township and village enterprises (TVEs) that formed the backbone of the emerging private sector; the "red hat" strategy was also moving into urban areas.[33] A 1988 survey conducted in Wenzhou identified "45,000 privately owned firms of various forms under the banner of collective enterprises, but only 10 registered private enterprises".[34]

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[30] Tsai defines adaptive informal institutions as regularised patterns of interaction that emerge as responses to the restrictions and opportunities of formal institutions. She also refers back to a special case of path dependency — "reactive sequences". This identifies feedback mechanisms within institutions that generate the unfolding of paradoxical, unintentional consequences that in turn lead to the spread of a sometimes different, even opposite turn of development. The constant factor in this process of non-linear institutional development is a nature of change below that of systemic change: "That is, short of authoritarian breakdown, it is plausible that significant changes could nevertheless occur within the apparent limits of the existing political system" (Tsai, "Adaptive Informal Institutions and Endogenous Institutional Change in China", p. 120).

[31] Tsai, "Capitalists without a Class", p. 1136.

[32] See Chen Wenhong, "Does the Colour of the Cat Matter? The Red Hat Strategy in China's Private Enterprises", *Management and Organization Review* 3 (2007): 58.

[33] In a nutshell, TVEs could develop rapidly once they received support from subnational governments in getting access to credit. They lost this privileged position in the first credit crises of the early 1990s and with it a key competitive advantage. This resulted in strong pressure for further reorganisation.

[34] Chen, "Does the Colour of the Cat Matter?", p. 57.

All in all, this practice of layering demonstrates an informal adaptive institutionalisation that gradually altered the formalised institutional framework of company management. Over the course of time, the popularity and success of this practice led to support at both the local political level — important for local economic development — and also among leaders within the power elite pushing for reform.[35]

As a consequence, several official political reforms in the late 1980s and early 1990s showed signs of an institutional conversion to replace the informal rules that had hitherto prevailed. For example, the discourse on private sector development in Wenzhou prepared the ground for new national regulations that improved the legal standing of private firms. "In 1988, the State Council issued the Private Enterprise Law and a subsequent constitutional amendment acknowledged the private sector as a supplement to the socialist public sector".[36] After the Party's reform wing finally halted the rollback between 1989 and 1991, the process of layering again began to quicken.

The Second Phase of Reform

From the early to mid-1990s, a large number of "red hat" employers — enabled by the Communist Party of China's (CPC's) endorsement of China as a "socialist market economy" and the enactment of a new Company Law — began to register officially as private businesses.[37] Thereafter, the official private sector grew by an average of 35 per cent per year. In lieu of the "red hat" strategy, the ascent of thickly embedded private capitalists and "red capitalists", in the main private entrepreneurs who were CPC members, became critical factors in the second phase of transition, as argued, for example, by Bruce J. Dickson.[38]

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[35] Several factors contributed to subnational political entities that partially renounce their control over wealth by transferring economic power to private actors. These factors included: the willingness of many local leaders to experiment with new methods of political development because of the decades of want and instability; the changes in central government tax legislation of the 1980s offering greater financial scope to compensate possible losses resulting from local economic reforms; the consequences of transferring responsibility to managers and the increased efficiency gave impetus for further modernisation. Although legal proceedings against red hat practices were possible, these did not dominate the reform process. The success of the red hat strategy marginalised anti-market forces within the Party-state. In reality, no strict dividing line existed between legitimate business practices and illegal activities or forms of corruption that were punishable by law.

[36] Chen, "Does the Colour of the Cat Matter?", p. 60.

[37] Chen and Wang, "The Reform, Opening, and Development of China's Industrial Economy", p. 47. Another example is the possibility of registering as "limited liability companies," typically formerly COEs, of between two and 50 shareholders with a limited shareholder status. They gained in importance, which was possible among other things by a clause in the Corporations Act of 1994 that permitted the reforming of "public" companies as limited liability companies.

[38] Bruce J. Dickson, *Red Capitalists in China: The Party, Private Entrepreneurs, and Prospects for Political Change* (Cambridge: Cambridge University Press, 2003); Bruce J. Dickson, "Integrating Wealth and Power in China: The Communist Party's Embrace of the Private Sector", *The China Quarterly* 192 (2007): 827–54.

Concerning thickly embedded private capitalists, the explosive growth of the private sector in some ways fostered the rags-to-riches rise of many businessmen. At the same time, the *Hurun Rich List* — a Chinese equivalent of *Forbes* — which in 2010 ranked 1,363 individuals with personal wealth of at least one billion Chinese *yuan* (USD150 million), reveals that "12 per cent of those listed had been appointed to significant government advisory posts, handing them a powerful platform in a business climate that values official contacts".[39] This has also been the trend for the lower and medium echelons of the private sector. Many entrepreneurs — e.g., many of the businessmen in Zhejiang province who work predominantly in the most competitive or the most marketised sectors — either belong to or have close ties to political bodies (e.g., the local People's Congress and People's Political Consultative Conference), or have taken part in village elections. All in all, concerning the "red capitalists", an estimated one-third of the richest individuals in the Hurun Rich List are CPC members.

At the beginning of the most rapid phase of the private sector's expansion, the transformation processes resulted in new private-public alliances between economic and political power elites that also manifest as actual personal unions. And empirical studies point out that closely interwoven politico-business interaction is typical not only for CPC membership.[40]

The corporatisation and, later, privatisation of mainly small and medium-sized SOEs was another key contributor to private sector growth after the mid-1990s — between 1998 and 2006, the number of SOEs shrunk from 238,000 to 119,000.[41] This was especially important in introducing a legalised process for privatising state-owned firms (*gaizhi*) whereby managers could acquire their firms at a price based on recent profitability.[42] These cases of "management buyouts" (MBO)[43] point to the fact that in many instances, CPC cadres took on the role of "red capitalists". Even prior to the legalisation of private property and "even though CCP [CPC] members were not allowed to operate private businesses, it was apparent throughout the 1980s

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[39] See "Zong Qinghou of Wahaha tops Hurun Rich List 2010", *Hurun Report*, at <http://www.hurun.net/hurun/listreleaseen512.aspx> [29 Sep. 2012].

[40] Christopher A. McNally, Guo Hong and Hu Guangwei, "Entrepreneurship and Political Guanxi Networks in China's Private Sector", *East-West Center Working Papers: Politics, Governance, and Security Series* 19 (Honolulu: East-West Center, 2007), pp. 9–10.

[41] Chen and Wang, "The Reform, Opening, and Development of China's Industrial Economy", p. 44; see also Jean C. Oi and Han Chaohua, "China's Corporate Restructuring", in *Going Private in China*, ed. Oi, pp. 19–37.

[42] The Chinese stock market also encouraged the privatisation of large companies by opening up new avenues of capital procurement for SOEs from new shareholders.

[43] As the following remark about a former SOE indicates, MBOs became increasingly common — "to the point that the headline in the city's newspaper in January 2003 proclaiming the [firm's] imminent privatization simply used those three English letters 'MBO' instead of the equivalent Chinese characters, as if most newspaper readers would instantly recognise the English-language acronym for a management buyout" (Anita Chan and Jonathan Unger, "A Chinese State Enterprise under the Reforms: What Model of Capitalism?", *The China Journal* 62 [2009]: 1–26, 22).

and 1990s that many were active participants in the non-state sector. Indeed, official surveys reveal an increasing proportion of self-identified CCP members among private entrepreneurs over time, such that only 7 per cent of business owners admitted to being [P]arty members in 1991, but by 2003 over one-third admitted to being [P]arty members".[44]

Furthermore, as Dickson documents, the "larger the 'sales revenue' of a firm, the more likely its owner is a Party member", and the more likely that Party organisations exist in their firms.[45] It is often those capitalists who operate the largest firms who "are the most likely to be involved in the political arena. Indeed, most of them […] are more likely to support the […] existing authoritarian political system rather than pose a direct challenge to it. This is a key element of the CCP's strategy for survival, and so far it is working".[46] "Co-opted" entrepreneurs state in surveys that the main reasons for joining the Party are the economic advantages and connections to the political sphere.[47]

The shift from individual *control* to formal individual *ownership*, and the legal changes this involved, proceeded over several years. The Party leadership reacted by changing its attitude to private enterprise. This is evident from legalisation of Party membership for entrepreneurs (2001), the constitutional amendment on assurances for private property (2004) and finally the announcement on property rights (2007) that formally gave the same protection to both private and public property. Although private entrepreneurs in practice remained more or less absent from this process, the political power elite gave the All-China Federation of Industry and Commerce credit "for representing the voice of private entrepreneurs and pushing for the private property clause to create a stronger political case for revising the constitution along the lines that they had been hoping for".[48]

Generally speaking, the remarkable ascent of China's private sector led to a gradual, yet transformative change in policies. Where informal coping strategies once reigned, an acknowledged private sector now prevails. However, this process should not lead to prematurely concluding that there has been a simple transition to a liberal market economy. Private property remains embedded in the (often local) political scene and in many ways, it is the State, not the individual firm that "decides when and how restructuring takes place".[49] The forms of recombinant property in China are characterised by an extraordinary influence from state actors and state entrepreneurialism, even when property takes on new forms. This is shown in the next section.

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[44] Tsai, "Adaptive Informal Institutions", pp. 132–3; Tsai, *Capitalism without Democracy: The Private Sector in Contemporary China*, pp. 72–104.

[45] Dickson, "Integrating Wealth and Power in China", pp. 839–40.

[46] Ibid., p. 852.

[47] Ibid., pp. 841–2; Dickson, *Red Capitalists in China: The Party, Private Entrepreneurs, and Prospects for Political Change*, pp. 162–4.

[48] Tsai, "Adaptive Informal Institutions", p. 139.

[49] Oi and Han, "China's Corporate Restructuring", p. 27.

THE EMBEDDING OF THE ENTERPRISE IN CHINA

The corporate sector has to be analysed against the broader background of Chinese multi-level governance, intraregional competition, state entrepreneurialism and private-public networks on the one hand, and the politics of the central state on the other. This leads to the conclusion that the transformation process amounted to a hegemonic project of the "private-public" Chinese power elite. However, to avoid the trap of state-centred theories, with the Chinese leviathan as a clever, forward-looking force shaping the economy,[50] one must bear in mind the favourable external opportunity structures that existed.[51] This article does not fully consider these but they did equip the ruling class with the means to cope with the hazardous path of allowing the private sector to grow, and to muddle through the reform process of the 1980s and 1990s into what one may call an almost hegemonic rule of the 2000s.

Intraregional Competition, State Entrepreneurialism and Private-Public Networks

The bottom-up processes that stimulated the creation of a huge private sector were placing major pressure on different levels of the State. But due to the State's obsession with growth and the sub-national competition between different state bodies, political administrations were able to act in a relatively compatible way.

In a sense, the structural interdependency between economic and political actors in capitalist systems generally assumes a particularly close correlation in China. Nevertheless, it has not assumed a monolithic form. It is impossible to understand the economy without reference to both the diverse fragmentation and varieties of corporate restructuring below the level of the central state. The state in China could possibly best be defined as a "diffuse" capitalist developmental state.[52] This also includes subnational governments which allow local enterprises to violate national labour laws. Since the subnational political levels have assumed the role of a local developmental

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[50] Dali L. Yang, *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Stanford, CA: Stanford University Press, 2004).

[51] In the 1980s, East Asian countries — and, in a sense, their business sectors — became role models for China. As older guiding principles of Maoism eroded, a new agenda for development appeared and, for instance, several existing governmental agencies were merged into the Ministry of Foreign Economic Relations and Trade (MOFERT). Henceforth MOFERT, later the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and finally, the Ministry of Commerce (MOFCOM) became a form of intra-governmental *avant-garde* that propelled the exportist regime forward.

Additionally, the overseas Chinese fuelled the country with FDI and their entrepreneurial spirit. In the 1990s, China became the most attractive location for production and entrepreneurial activities in the world when an over-accumulation of capital, classified as a capital investment crisis, hit the traditional production centres in the West. The reform process was, in contrast to the Soviet *nomenklatura*, mastered not only due to exceptional strategic skills or self-confidence, but also due to many fortunate coincidences (see ten Brink, "Strukturmerkmale des chinesischen Kapitalismus", pp. 33–40).

[52] McNally and Chu, "Exploring Capitalist Development in Greater China", p. 54.

state, they attempt to build settings conducive to success by creating incentives to stimulate economic efficiency in their territories by means of support, supervision of and direct involvement in companies. Major investments in infrastructure, development of "supply-chain-cities" and specialised single-product clusters in the coastal area are good examples of incentives created. Internal competition between subnational bodies vying with one another to attract investors has driven economic development. Government officials or state managers are thus often substitutes for entrepreneurship. This creative, though frequently corrupt commercial activity is in a way reminiscent of the Schumpeterian entrepreneur, but in a novel "state-capitalist" sense.[53]

Hence, the "state" and the "market" cannot be regarded as being mutually exclusive. Conventionalised, counter-juxtaposed concepts of private and state actors do not really clarify the situation in China.[54] Because government jurisdictions are subject to *competitive* pressures, the capacities involved in accumulation activities by local political institutions or local government officials in China have a lot in common with private capitalist companies or managers.

Although the frequently mentioned *guanxi* networks — closely personalised and affective forms of interaction and empathy — lend the Chinese economy a high degree of particularised coordination, it occurs within the confines of a competitive society. As part of the growing monetisation of social relations, these private-public alliances do not, as assumed by neoclassical theory, constitute a gradual transition to a "pure" market. Instead, they are themselves to be regarded as a form of marketization.

Wank adds to this assessment the assumption that, in the course of the reform process, a change in the power configuration emerged between industry and government, with corporate strategies exerting more influence on the behaviour of local political bodies. Greater dependency on the activity of entrepreneurs is manifested in a new kind of competition set-up: "Previously, citizens competed to enter officials' patronage networks. […], now officials also compete with each other for links to larger private companies, with successful ones becoming shareholders and managers".[55]

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[53] Interestingly, for Schumpeter, the entrepreneur is not necessarily a self-employed businessman, but anybody who takes on the entrepreneurial "function" of promoting "new combinations" (Christoph Deutschmann, "The Entrepreneur in Economic Sociology", *Conference Paper* [Paris: Society for the Advancement of Socio-Economics Annual Meeting, 15–19 July 2009], p. 5). As can also be seen in instances of innovation processes in Western countries, entrepreneurialism should be conceived as a more collective process in contrast to the Schumpeterian mainstream. Even when employers see the role of local governments to be of very limited and tangential importance to success, businesses are in truth shaped by numerous supportive institutions (Andrea M. Herrmann, "Against the Schumpeterian Mainstream: A Review of Institutional Approaches to Entrepreneurship", *Socio-Economic Review* 8 [2010]: 735–46).

[54] For early evidence, see Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy", *American Journal of Sociology* 101 (1995): 263–301, 268.

[55] David L. Wank, *Commodifying Communism: Business, Trust, and Politics in a Chinese City* (Cambridge: Cambridge University Press, 1999), p. 198.

The result is not the automatic appearance of autonomous areas in civil society but rather semi-autonomous network communities of political and private actors whose economic development concepts are relatively independent of central government bodies. Newly founded institutions at the local level (e.g., chambers of commerce or other non-governmental entrepreneurial civic associations) exemplify this trend.

This system of multi-level governance is subject to continuous bargaining and contracting within the administration, and between the administration and the business sector. At the same time, local institutional competition appears to be of utmost importance as a coordination mechanism.[56] Similar to the federal political structures and interregional competition that formed the backbone of industrial growth in the US in the 19th century, the "*de facto* federalism"[57] in China stimulates the dynamics of its economy.

The Central State and its Capacity to Steer and Reform from Above

In a way, political institutions in China create the framework within which both the market-oriented state capitalist and the private entrepreneur can operate. With regard to the central state, the government did not merely adopt capitalist growth policies, individual entrepreneurialism and active support in privatising SOEs. There was and still is another central-state role that is not to be underestimated: the provision of an overarching institutional architecture that accommodates competition. One political strategy regularly used by the regime to gradually initiate reform was to introduce change in only a few test areas, e.g., in Wenzhou or in Guangdong province, followed by a wider introduction of the policy when the test proved successful. Despite the fact that experimentation procedures have been delegated to local authorities, the central administration in Beijing plays an indispensable role in universalising local innovations thereby generating coordination into the Chinese policy cycle.[58]

This capacity at the macro level can be interpreted as *experimentation under hierarchy*: "The 'federalism, Chinese style' approach suggests that hierarchical governance has been replaced by administrative decentralisation, jurisdictional competition and central-local bargaining. Although these factors play an important role in central-local interactions, and local governments clearly feel more confident and secure today

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[56] Barbara Krug and Hans Hendrischke, "Framing China: Transformation and Institutional Change through Co-Evolution", *Management and Organization Review* 4 (2008): 81–108, 94–5.

[57] Zheng Yongnian, *De Facto Federalism in China: Reforms and Dynamics of Central-Local Relations* (Singapore: World Scientific, 2007).

[58] Chen and Wang, "The Reform, Opening, and Development of China's Industrial Economy", pp. 77–9.

in making local policies, none of these changes has eliminated the weight of hierarchy and ad hoc central interference in China's political economy".[59] In other words, experimentation "from below" required patronage that might be the go-ahead from higher-level policy-makers through either non-intervention or encouragement and public backing.

Thus, the background of a competition-driven form of multi-level governance in China and the anarchic processes concerning the (internationally embedded and dependent) economy should not lead to any premature conclusion that the central state is growing weaker.[60] In fact, it is precisely its partial erosion in the first phase of reform that lent the central government and the rule of the Party new legitimacy from the 1990s onwards. One important example of this is the extractive power of the central state: in the second phase of reform, and particularly since the tax reforms of 1994, the central state has been able to recentralise resources to a considerable degree. In terms of its own modernisation, several waves of bureaucratic restructuring led to strong (supra)ministerial institutions such as the Ministry of Commerce (MOFCOM), or the National Development and Reform Commission (NDRC), which is now a hub in industrial development organisation.[61] Additionally, many of the large centrally controlled state enterprises, which were restructured and are now mostly listed, were brought together from 2003 onwards under the State-owned Assets Supervision and Administration Commission (SASAC). The founding of SASAC marked a milestone in the restructuring of state-owned business groups that act as a form of reliable consumers for numerous "red" suppliers and other private subcontractors.[62] In the state-controlled telecommunications sector, for instance, numerous privately-owned "chip-design companies" produced a range of equipment for the Chinese 3G standard.

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[59] Sebastian Heilmann, "Policy Experimentation in China's Economic Rise", *Studies in Comparative International Development* 34 (2008): 1–26, 11; Zheng Yongnian, *The Chinese Communist Party as Organizational Emperor: Culture, Reproduction, and Transformation* (London: Routledge, 2010); Barry Naughton, "China's Economic Policy Today: The New State Activism", *Eurasian Geography and Economics* 52 (2011): 313–29.

60 Merle Goldman and Roderick MacFarquhar, "Dynamic Economy, Declining Party-State", in *The Paradox of China's Post-Mao Reforms*, ed. Merle Goldman and Roderick MacFarquhar (Cambridge, MA: Harvard University Press, 1999), pp. 3–29.

[61] Tony Saich, *Governance and Politics of China* (Houndmills: Palgrave Macmillan, 2004), pp. 121–36.

[62] Ma Xufei and Jane W. Lu, "The Critical Role of Business Groups in China", *Ivey Business Journal* 69 (2005): 1–12; State-Owned Assets Supervision and Administration Commission of the State Council, *General Information on Reform and Development of Central SOEs & Development of State-Owned Assets Management System Reform*, 2006, at <http://www.sasac.gov.cn/n2963340/n2964712/3059894.html> [25 July 2011].

INSTITUTIONAL TRANSFORMATION, HEGEMONY — AND INSTABILITY YET AGAIN!

With regard to the evolution of the Chinese society as a whole, gradual institutional change through the mechanism of layering and conversion has served not just the new private or semi-private entrepreneurs. Reform policy has also served the interests of the state bureaucracy and the Party. While the success of enterprise restructuring in China cannot be explained without including the favourable *external* opportunity structures, there remains the fact that in the 2000s, *internally*, the interdependencies between Party, State(s) and entrepreneurs provided a strong alliance that created space for experimentation as long as growth rates remained high.

Thus, "communist" party-rule, a strong state and "Chinese-styled market liberalism" have not undermined one another. Therefore, rather than seeking autonomy, many private capitalists have pursued a combination of institutional and affective ties that "thickly embed" them with the Party-state.[63] The increasing socioeconomic mobility of entrepreneurs has to an extent been facilitated by their ties with the regime so they have had little reason to criticise it. On the contrary, the common interests of the Party bureaucracy, the State, and private capitalists frequently lead to common viewpoints. "In contrast to the popular perception that privatisation is leading inexorably to democratisation, […] the most recent survey data suggest that [private businessmen] are increasingly integrated into the current political system. […] This again suggests that the growing shared interests of government and business are creating an environment that supports the status quo, rather than one in which businessmen are motivated to press for change".[64]

The emergence of a new economic regime, which is articulated in State and private-public projects, underpinned a relative societal coherence, especially from the mid-1990s into the 2000s. Gradual institutional change through layering and conversion would not otherwise have proceeded to the same extent.

Because markets, however, tend to have a destabilising impact on their institutional framework and resist institutionally imposed stabilisation and control, a "harmonious society" may prove difficult to achieve in the years to come. Since China is no exception to the rule of contradictions and strategic dilemmas inscribed in capitalist market relations, the continuity of the Chinese trajectory has been, in recent years, threatened by the crisis-prone processes of its integration into global economic structures and the tendency for internal crises to develop.

In particular, the growth model faces obstacles both from a continuing dependence on exports and the ways in which Chinese firms (e.g., private businesses that are entrenched in global production networks) are reliant on foreign markets. Furthermore,

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[63] Christopher A. McNally and Teresa Wright, "Sources of Social Support for China's Current Political Order: The 'Thick Embeddedness' of China's Private Capital Holders", *Communist and Post-Communist Studies* 43 (2010): 189–98.

[64] Dickson, "Integrating Wealth and Power in China", p. 852.

these trends, driven by internal competition among subnational political bodies vying to attract investors, have contributed to an overinvestment and duplication of capital expenditure. Government strategies for industrial restructuring in the wake of global downturn addressed some of these problems, but the huge stimulus plans and the related reorganisation of industrial assets might also accelerate over-accumulation due to their massive bias towards fixed capital formation.[65] In addition to this, societal polarisation endangers social stability.[66] Without a doubt, all this will again change China's path of reform in the years ahead.

[65] Barry Naughton, *The Policy Challenges of Post-Stimulus Growth*, 2010, at <http://www.globalasia.org/print.php?c=e287> [25 July 2011].

[66] The government therefore aims to make the transition from export-driven growth to a more domestically-centred model based on internal consumption. But these "rebalancing" efforts have proved to be very difficult. The already high investment rates of up to 40 per cent of GDP after 2000 have escalated since 2008 to an almost spiralling height of 50 per cent. This has resulted in rising excess capacities that feed into a sustained export orientation which, in turn, hinders efforts in political rebalancing. Additionally, considerable regional differences in the level of development and China's immense internal polarisation impede a stable path of development.