A China Model?
Understanding the Evolution of a “Socialist Market Economy”

Orion A. Lewis
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Glasshouse Forum

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Foreword

In February 2009, Glasshouse Forum convened leading academics to a China-West Intellectual Summit in Paris.

The starting point for the discussion was that 20 years have now passed since Francis Fukuyama launched his renowned thesis on the end of history. Liberal democracy on a capitalistic base had triumphed over its rivals. Those who did not adopt this system would be hopelessly outdistanced. The country that most clearly refutes this hypothesis is China. It has seen unparalleled economic development at the same time as the regime has retained its grip on society and the economy. Significant voices in the Chinese debate hold that China should not try to emulate the West, but find its own way.

Can one speak of a Chinese model, an authoritarian capitalism, which may even inspire others, in particular now when the crisis emanating from the USA is leading many to look critically at the West? It is noteworthy that nobody at the meeting championed Fukuyama's thesis, nobody saw any signs of China adopting liberal democracy.

It was also manifest that the Chinese participants considered China well positioned to handle the global economic crisis. There was uncertainty however over how to characterise the system in China and how one might theoretically describe the major changes that have taken place in recent decades. Representatives for the Chinese "new left" underscored the socialistic element, but it is not easy to grasp what "socialist market economy" in fact means. How should one define the Chinese economic model? What are the differences and similarities in the state's role in the market and welfare provision when compared to American liberal capitalism, the European social model and the Scandinavian welfare model?

There was no really satisfactory answer to these questions during the China-West Intellectual Summit, and Glasshouse Forum therefore asked the American political scientists Orion A. Lewis and Jessica C. Teets of Middlebury College to try to clarify matters in a comparative perspective, and to discuss the implications of the global economic crisis on China's socialist market economy. This is their report.

Glasshouse Forum, August 2009

Executive Summary

By comparing China's successful experience with market transition to that of Russia, we can see that China transitioned from a command to a market-based economy without the negative consequences of "shock therapy" by following a paradigm of gradual institutional reform based on the method of decentralized experimentation. Chinese leaders use the term "socialist market economy" to describe the resulting hybrid capitalist system comprised of a simultaneous state-supported and private sector. The ambiguity of this term, along with the ever-changing dynamics of economic reform in China, leads to the question of how to understand the balance of socialism and capitalism that exists in a socialist market economy.

Part of the difficulty in understanding the Chinese market is that it attempts to bridge the state-market relationship under a command economy with one under a market economy. The relationship between the state and the market follows a gradual evolutionary path, where policy constantly adapts to changing political and economic obstacles to further reform. The slogan "crossing the river by groping for stepping stones" (*mozhe shitou guo he*) most accurately describes this economic reform process. Instead of emulating a specific model of capitalism, Chinese leaders desire to promote a uniquely Chinese model of development.

We contend that the development of the socialist market economy is shaped primarily through elite disagreement over the appropriate relationship between state and market, and resembles an ad-hoc series of compromises between neo-liberal reformers on the right and the socialist left rather than a coherent "China model" of development. Neo-liberal market reformers dominated economic policy during the post-Tiananmen period of the 1990s, pushing through reforms to downsize the state-owned sector and transition to more of a regulatory state. However the "new left" – critical of neoliberalism and advocating greater social welfare – has emerged as an important political force in recent years. This current global economic crisis amplifies this trend, creating important implications for understanding China's future economic policy.

Defining the "Socialist Market Economy"

The central paradox of China's rapid economic transformation is how a resilient authoritarian state presides over a free-market economy while still maintaining socialist values.[1] From a comparative "varieties of capitalism" perspective, the Chinese model has defied easy categorization as it is a hybrid economy mixing elements of the communist legacy with multiple models of capitalist market transformation. In order to understand how China arrived at this system and its likely future, it is important to point out that the Chinese system is the product of the unique evolutionary path that the leadership has followed to overcome economic and political obstacles to reform.

Given the monumental task of transitioning from a command economy to a market-driven one without political collapse, the Chinese Communist Party (CCP) consistently engaged in a process of gradualist economic reform. Utilizing a long-entrenched method of decentralized experimentation, or "proceeding from point to surface" (*youdian daomian*), the CCP adhered to a reform process characterized by gradual strategic adaptation rather than fully importing foreign economic models, as was the case in Eastern Europe and the former Soviet Union.[2] Thus the Chinese economy is a mixture of different economic models, reflecting both historical legacies and differing ideas about the proper role of the state in the market.

Under Mao Zedong's leadership (1949–1976), the party-state administered a command economy with state agencies issuing production and price guidelines to a state-owned enterprise (SOE) system, with a strong emphasis on social and economic equity.[3]

1) This paradox is outlined by a leading new left scholar Wang Hui in Pankaj Mishra, "China's New Leftist", *The New York Times Magazine*, October 15, 2006.

2) Sebastian Heilmann, "From Local Experiments to National Policy: The Origins of China's Distinctive Policy Process", *The China Journal* 59 (January 2008).

3) Dali L. Yang, "Economic Transformation and Its Political Discontents", *Annual Review of Political Science*, 9 (2006): p.155. In this report, we use the term "party-state" to refer **(cont. on p. 9)**

When Deng Xiaoping (1978–1992) took control, he began the process of economic reform, or "reform and opening" (*gaige kaifang*). During this time period, special economic zones (SEZs) were established along the coast to attract foreign investment, and regulations prohibiting the creation of private enterprises lifted. Many government officials "jumped into the sea" of capitalism and started private enterprises or quasi-private enterprises such as Town and Village Enterprises (TVEs), which were technically local SOEs but in fact were often political covers for private enterprises. The quasi-private enterprises were referred to as "wearing the red hat" and drove the majority of economic growth in China in the 1980s.[4]

This gradual and inclusive process facilitated the growth of a private market without threatening the political hegemony of the ruling elite as occurred in the transition economies of Eastern and Central Europe.[5] From Deng Xiaoping's rule through both Jiang Zemin (1993–2003) and Hu Jintao (2003–present), the socialist market economy describes a mixed system with both private firms and a state-owned sector operating concurrently.

Disaggregating the China Model

Analysts recently question whether the China model, or a "Beijing consensus", has overtaken US-style capitalism as the model favored by the developing world.[6] However, as we explain in this section, a China model does not exist as a coherent strategy. The socialist market economy in China is comprised of three different models of state-market relationship operating concurrently: the state-owned sector, the directed sector, and the private sector.

The state-owned and directed sector consists of three different types of firms: central and local SOEs, local TVEs, and private firms categorized as pillar industries. The SOE sector and a policy of strong state intervention in the economy are the key identifying characteristics of the China model.

Representing the legacy of the communist past, the party-state directly controls SOEs, which are funded primarily through state-owned banks. The SOE sector is currently comprised of 159 enterprises under central government control in such key areas as utilities, heavy industries, and energy resources.[7] These SOEs own and control tens of thousands of subsidiary firms. In this part of the economy, the state's relationship with these firms is similar to the previous command economy. However, the party-state requires that these firms earn profits if possible, introducing market mechanisms that did not exist under the command economy. In fact, unprofitability is one criterion the party-state uses to decide which SOEs to merge or privatize. In this way, SOEs operate similarly to the private firms in the state-directed sector.

Many analysts attribute China's recent double-digit growth to the turnaround and re-positioning of SOEs into a hybrid mix of capitalism and government ownership. As the Pacific Basin Economic Council explains, "A decade-ago, at the time of the Asian financial crises, Chinese state-owned enterprises (SOE's) were aging dinosaurs, broke and contributing little other than headwinds to economic growth, with millions of unproductive workers on their payrolls. However, within a decade, this situation has been 'miraculously' reversed, with four SOE's currently among world's ten largest multinationals by market capitalisation, including PetroChina (the world's largest oil company), China Mobile (the world's largest telecom), Industrial and Commercial Bank of China (the world's largest bank) and Sinopec, a second state-owned oil company."[8] SOEs

to the fact that the CCP exerts control over the state to such an extent that to semantically divide the two actors would be analytically misleading.

4) Kellee S. Tsai, "Informal Adaptive Institutions and Endogenous Institutional Change in China", *World Politics* 59 (October 2006): 116–41.

5) Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions", *World Politics* 50 (January 1998): 203–234.

6) Ariana Eunjung Cha, "China Uses Global Crisis to Assert Its Influence", *The Washington Post*, April 23, 2009.

7) Becky Chiu and Mervyn K. Lewis, *Reforming China's State Owned Industries and Banks*, Edward Elgar Publishing, 2006: 10–11.

8) "Country Focus: China", *PBEC Priority Issue Areas*, July 2008, accessed at www.pbec.org on April 28, 2009.

listed on international stock markets and had profits in 2007 totaling US$140 billion, with overall profitability up 200 percent in the last five years.[9]

The party-state policy toward SOEs has been to reform the bigger and more profitable ones while privatizing or closing the small, unprofitable firms. Privatizing and downsizing this sector has occurred in a piecemeal and gradual fashion based on the lesson of the shock therapy policies that characterized the Eastern European transition to market capitalism – rapid institutional change was socially de-stabilizing and could be economically disastrous in its reappropriation of public assets, as in the case of Russia.[10] Instead, China sought to gradually privatize this sector in a way that allows laid-off workers to be absorbed by the growth of the other sectors of the economy. In the early 1990s, the SOE sector comprised 50 percent of GDP, collectives such as TVEs 40 percent, and private enterprise 10 percent.[11] More recent estimates reflect the gradual downsizing of the state-owned sector and the rapid growth of the private sector. Analysts now find that a third of the economy is directly state-controlled, with private-sector composition of GDP at 59.9 percent.[12] However, the presumption that SOE downsizing will continue apace has been called into question by the current global crisis as the state has dramatically increased its support for key sectors of the economy with a huge fiscal stimulus package.[13] One estimate contends that if the government continues to reform SOEs (privatizing, selling pieces of the companies, or closing them down) at the same rate as the 1990s, 100–200 million new jobs must be found to absorb laid-off workers.[14]

Another part of the state-controlled and directed sectors – local TVEs – represents the legacy of the initial stage of economic reform.[15] They are often run as private firms but generally place the local leader in an executive position, such as on the board of directors. The local party leader helps guide the firm through the regulatory regime, protects it from competition, and directs funding from local bank branches; however, the production goals and strategies are developed by the firm. As a result, the developmental state is heavily involved in supporting firms, but their success or failure is relatively more conditioned by the market than the SOE sector.

However, this segment of the economy is particularly confusing for foreign investors as the level and type of state involvement is non-transparent.

The last segment of the state-owned and directed sectors consists of state control over key strategic private industries such as software development, biotechnology, automobiles, medical devices and supercomputers. This segment, also known as the "commanding heights" of the economy, remains a central element of the China model.[16] This segment of the Chinese economy closely resembles the East Asian developmental model, where the party-state guides industrial development by directing funding to favored firms. At the central level, these firms known as "pillar industries" or "national champions" are guided by state directives. While the party-state does not directly control these firms as they do with the SOEs, the party-state guides firms by setting production and market goals, protecting them from international and domestic competition, and directing funding through state-owned banks.

The remaining part of the economy is comprised of private firms, usually small and medium-size enterprises. In this sector, the party-state operates more like a regulatory state, monitoring and

9) George Dyer and Richard McGregor, "China's Champions: Why State Ownership Is No Longer Proving a Dead Hand", *Financial Times*, March 17, 2008.

10) Andrew G. Walder, "The Party Elite and China's Trajectory of Change", *China: an International Journal* 2.2 (2004): 189–209.

11) *China: Reform of State Owned Enterprises*, Washington DC: World Bank, 1996.

12) *Economic Surveys: China*, OECD [Organisation for Economic Co-operation and Development], Paris: OECD, 2005: 125.

13) "Bamboo Shoots of Recovery", *The Economist*, April 16, 2009; "So Much for Capitalism", *The Economist*, March 5, 2009.

14) Marcus Chadwick and Tianbiao Zhu, "China", Darryl Jarvis, ed., *International Business Risk*, Cambridge: Cambridge University Press, 2003: 59.

15) TVEs were the organizational form that first allowed local party members to "jump into the sea of capitalism" in the 1980s.

16) Wang Mengkui, ed., *China's Economic Transformation over 20 Years*, Beijing: Foreign Languages Press, 2000.

regulating firms but not directly guiding firm goals or funding. These firms have been successful in both the domestic and international market; however, they have not increased their size or production capacity that much. These firms face difficulty in securing loans from state-owned banks which tend to finance the SOE and government-directed sectors. According to surveys, more than 80 percent of private small and medium-size enterprises consider their lack of access to finance to be a serious growth constraint.[17]

In general, the conception of a China model and the specific makeup of the socialist market economy remain somewhat vague, due to the dynamic nature of reform and the pendulum shifts between socialist policies that emphasize equity and public ownership and neo-liberal policies emphasizing individualism and property rights. In short, we argue that instead of an economic grand strategy, the China model is the aggregation of the various political compromises that have occurred at each stage of reform necessary to overcome obstacles to further change. Moreover, the Chinese economy is the product of localized institutional experimentations, such as TVEs, that have facilitated a process of learning that ultimately informs national policy. While certain lessons from this process can be applied elsewhere, the Chinese economy is much more analogous to a path-dependent complex adaptive system containing elements of multiple economic models than a coherent economic strategy that can be quickly and readily copied by other countries.

Elite Debate in China: a Regulatory or Developmental State?

In his book on great transformations in capitalist societies, Mark Blyth points to the existence of Knightian uncertainty as an important environmental condition that precipitates institutional reform.[18] Under these conditions, also know as critical junctures, new ideas about the economy shape the formation or reform of economic institutions. The Chinese phrase "crossing the river by groping for stones" used to describe the process of economic reform illustrates that Chinese reformers have faced several periods of uncertainty during the economic transition. Under these conditions elite debate over economic policy and the search for successful models has played a particularly salient role in shaping economic institutions.

The first period of Knightian uncertainty occurred just after the Tiananmen Square incident in 1989, where many leaders such as former General Secretary Zhao Ziyang were purged from the party and replaced with "pragmatic careerists". Many of these pragmatists, such as former premiere Zhu Rongji were nevertheless protégés of Zhao Ziyang, and a relative elite consensus emerged around the policy of promoting rapid economic development and institutional reform as the best way to alleviate social tensions and develop China.[19] These reformers advocated neo-liberal principles, pushing policies to downsize the SOE sector, enter the World Trade Organization and dismantle the cradle-to-grave socialist welfare state. While post-Tiananmen policies fostered rapid economic growth during the 1990s and improved the "performance legitimacy" of the CCP in the wake of the Tiananmen incident, this period also saw the emergence of new challenges stemming from the contradictions of a free-market economy. Rapidly increasing income inequality, property-rights concerns and extreme environmental degradation all became key sources of social and political tension.[20]

A strong case can be made that China has now entered the second major period of uncertainty leading to a new search for ideas on the proper balance between equity and growth. In the mid-1990s the "new left" emerged as a reaction against the neo-liberal policies blamed for many of the negative externalities of rapid growth.

17) Marcus Chadwick and Tianbiao Zhu, "China", Darryl Jarvis, ed., *International Business Risk*, Cambridge: Cambridge University Press, 2003: 59.

18) Blyth defines change under Knightian uncertainty as situations regarded by contemporary agents as unique events where the agents are unsure as to what their interests actually are, let alone how to realize them. See Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*, Cambridge: Cambridge University Press, 2002.

19) Minxin Pei, "Political Reform in China: Leadership Differences and Convergence", *Carnegie Endowment for International Peace*, April 21, 2008.

20) Dali L. Yang, "Economic Transformation and Its Political Discontents", *Annual Review of Political Science*, 9 (2006): p. 156.

Leading new left thinkers, such as Wang Hui, the former editor of the influential magazine *Dushu* (*Reading*), have argued for a return to socialist principles in the form of greater social welfare provision, particularly for those groups left behind by rapid modernization – namely workers and peasants. Many of these thinkers are influenced by Marxist and socialist ideals, sometimes going as far as to assert that neoliberalism is a tool of Western powers and the "theoretical expression of the international monopoly capitalist class".[21] During this decade, the new left has seen its intellectual influence, and more recently its political influence, consistently rise. It has gone from a fringe intellectual group with little political clout, to an elite movement that increasingly informs state policy.

In terms of economic policy, the new left supports continued state ownership and greater developmental-state intervention in directing the market. However, unlike the old left of hardliner socialists, there is no question that the market is the fundamental driver of economic growth. The increasing policy influence of the new left is optimized by the current government's overarching policy framework of building a "harmonious society" (*hexie shehui*), first introduced in 2005.[22] This slogan essentially refers to a package of populist policies that seek to address the concerns of those "disadvantaged groups" (*ruoshi qunti*) that have been left behind by rapid development and the dismantling of the SOE sector and the social welfare state. Such policies have shifted the balance in favor of greater equity to address the concerns of groups critical of neoliberalism and better manage the societal impact of economic transition. Both President Hu Jintao and Premier Wen Jiabao have made numerous populist appeals to the socialist principles of the CCP and the need for greater social equity in economic policy.

At the same time the "new right" has seen its influence wane considerably. Neo-liberal advocates, such as Beijing University professor Zhang Weiying, argue for broader adoption of a US regulatory model of economic governance that continues to shrink the state-owned sector. According to Mark Leonard, Zhang "thinks that China will not be free until the public sector has been dismantled and the state has shriveled into a residual body designed mainly to protect property rights".[23] However, after dominating the reform

process in the 1980s and 1990s, the new right has found its influence on policy shrinking, with some opinion polls showing them to be the least popular group in China.[24]

Thus, beginning in the mid-2000s, moderate ideological factionalism re-emerges within the CCP with increasing opposition to further neo-liberal economic reforms. Debates over the controversial property rights law best illustrate this tension, as this reform would dismantle the last vestiges of the socialist economy – collective ownership of land and property. This law set a legislative record by failing to pass for at least six consecutive sessions of the national Congress before finally passing in a modified form in 2007.[25] First introduced in 2002 by neo-liberal reformers viewing private property as the fundamental legal foundation of a market economy, this law became the source of the first open ideological debate within the CCP in years.[26]

Prominent academics on the left, such as Peking University Law School Professor Gong Xiantian and Tsinghua University political scientist Cui Zhiyuan criticized the law for ignoring the communal aspects of property ownership and contradicting the constitution.[27] The resulting compromise, the implementation of which remains unclear, addressed these concerns by providing greater protection of public property and seeking to avoid contradictions with the constitution.

The inability of neo-liberals to push through a property rights

21) Joseph Fewsmith, "China Under Hu Jintao", *China Leadership Monitor* 14 (Spring 2005): p. 3.
22) Leslie Hook, "The Rise of China's New Left", *Far Eastern Economic Review* (April 2007).
23) Mark Leonard, "China's New Intelligentsia", *Prospect Magazine*, 144 (March 2008): p. 2; Zhang Weiying, "Has Economic Freedom Already Given Way to Democracy?" *Res Publica* 3, 1996: p. 7–16.
24) Mark Leonard, "China's New Intelligentsia", *Prospect Magazine*, 144 (March 2008): p. 3.
25) Leslie Hook, "The Rise of China's New Left", *Far Eastern Economic Review* (April 2007).
26) Songyan Sui, "New Property Law Shakes Up China", *BBC News*, March 8, 2007; Pankaj Mishra, "China's New Leftist", *New York Times Magazine*, October 15, 2006.
27) Pankaj Mishra, "China's New Leftist", *New York Times Magazine*, October 15, 2006; Leslie Hook, "The Rise of China's New Left", *Far Eastern Economic Review* (April 2007).

law highlights the subtle shift in influence that has occurred in Beijing over the last nine years. Increasingly leadership speeches and policy substance reflects the concerns of the new left for more equitable development and cessation of further neo-liberal reforms. Thus it is clear that economic policy, as it has been throughout the reform era, is compromise between elite factions.[28] For example, in discussing the 11th five-year plan unveiled in 2005, Mark Leonard argues that it is "a template for the new Chinese model. From the new right, it keeps the idea of permanent experimentation – a gradualist reform process rather than shock therapy. And it accepts that the market will drive economic growth. From the new left, it draws on concern about inequality and the environment and a quest for new institutions that can marry co-operation with competition."[29]

While policy shifts towards the new left were already underway before the global economic crisis, the crisis clearly accelerates this trend. The perceived failure of US-style capitalism has greatly undermined neo-liberals in China who would like to see a more complete dismantling of the state-owned sector. Conversely, according to elite politics experts Bo Zhiyue and Chen Gang, the crisis opens up avenues for the new left to promote a "state capacity" view of economic policy, where heavy state regulation and involvement in the economy are necessary to manage development.[30] The pressures of the global economic crisis, by exacerbating unemployment and social instability, serve to bolster the influence of the new left.

In 2008–2009, the party-state reasserted its role in the economy through a fiscal stimulus package, which as a percentage of GDP is much larger than a similar package passed in the US, and more substantial state support for and involvement in pillar industries.[31] The process of privatizing SOEs, while slowed considerably since the 1990s, might be slowed even further.[32] The global economic crisis and increasing social tensions raise the influence of the new left championing a softer form of capitalism – the European social-welfare state.[33]

In this regard, the critical juncture represented by the global economic crisis may play a role similar to the one played by the Great Depression in the United States, where the failure of free-market ideology created the political conditions for New Deal policies. According to Zhang Xudong, professor at New York University, the new left is looking for "a middle-of-the-road approach – a Scandinavian social model, the British welfare approach, or the US New Deal".[34] Thus, the shift in economic policy currently underway in China is analogous to that taken by the US following the Great Depression, and mirrors the shift toward greater state intervention in the economy taking place throughout the developed world.

Overall, while China has taken a historically-unique evolutionary path in its economic development, the relative emphasis on socialism or capitalism has followed a similar historical process as industrialization found in other developed countries. In this familiar pattern, rising inequality follows rapid industrial revolutions, the friction and social contradictions of which were addressed with more robust social welfare states. As Tsinghua University political scientist Cui Zhiyuan argues, "It is not helpful [. . .] to see socialism and capitalism as opposed and separate. Both have traveled together in the 20th century. Not just European welfare states, but even American capitalism has a socialist component, which was arrived at after compromise with the trade unions."[35] Thus China's current stage of development is analogous to the one major industrial social

28) Jing Huang, Factionalism in Chinese Communist Politics, Cambridge: Cambridge University Press, 2000.

29) Mark Leonard, "China's New Intelligentsia", Prospect Magazine, 144 (March 2008). See also Wang Chaohua, "Minds of the Nineties," in Wang Chaohua, ed., *One China, Many Paths*, London: Verso, 2003.

30) Zhiyue Bo and Gang Chen, "Global Financial Crisis and the Voice of the New Left in China", *East Asian Institute Background Brief No. 443*, March 26, 2009.

31) "So Much for Capitalism", *The Economist*, March 5, 2009.

32) Nouriel Roubini, "Outlook for China's Economy in 2009 and Beyond", RGE Monitor and New York University, April 2009.

33) Zhiyue Bo and Gang Chen, "Global Financial Crisis and the Voice of the New Left in China", *East Asian Institute Background Brief No. 443*, March 26, 2009: p. ii.

34) Leslie Hook, "The Rise of China's New Left", *Far Eastern Economic Review* (April 2007).

35) Pankaj Mishra, "China's New Leftist", *New York Times Magazine*, October 15, 2006.

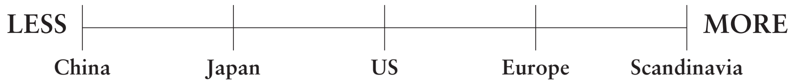
democracies found themselves in the late 19th and early 20th centuries, where rising inequality forced states to build social welfare states to correct the contradictions and excesses that occur in a free-market system and create property rights institutions that mediate conflicts.[36]

When comparing China's socialist market economy with other major models of capitalism, it is important to focus on two different aspects of the state-market relationship: the role of the state in economic development and degree of social welfare provision. As illustrated below (Figure 1), the Chinese perspective supports a much greater role for the state in economic development, making it closer to the East Asian developmental model than to either the US regulatory state or the Scandinavian corporatist approaches. Similar to the Japanese model the party-state believes the state should play an active role in guiding development; however, unlike the Japanese the party-state extends this role to include more direct ownership of firms and key industries.

Figure 1: *Model of the State's Role in the Market*

However, when comparing the degree of social welfare spending by the state, China falls in a very different place on the spectrum. As illustrated below (Figure 2), despite a very active role in the economy, the party-state has greatly reduced its role in the provision of social welfare. With the dismantling of the work-unit system (*danwei*), most welfare benefits such as unemployment insurance are now provided by local governments who generally cannot afford such benefits. Unless one is a government employee or SOE employee, most Chinese citizens do not have access to state-provided welfare benefits and instead depend on their family's own savings to provide for health, unemployment and other welfare needs.

Figure 2: *Model of State Welfare Provision*



Thus, along both of these dimensions the Chinese model is currently more similar to the Japanese model than the US, European, or Scandinavian models. However, the Chinese model diverges significantly in terms of greater state ownership and less welfare provision, which precludes it from being classified as an East Asian developmental state. During the 1990s the state sought to diminish its role in the market – a process that has halted as the current economic crisis has seemingly vindicated those supporting a strong state role. Instead, what we now see is movement along the second dimension with the debate focusing on how to grow the welfare state and what kind of "middle of the road" model China would like to follow.

The concept of socialist market economy is one that has evolved over time, reflecting ongoing debates within the Chinese leadership over the proper balance between equity and economic growth in the market-driven system. While ideological divergence regarding the particular model of capitalist China should follow remains, relative agreement exists around the need to build market-supporting institutions and a rule of law regime to resolve social and economic conflicts.[37] While affirming maintenance of social stability and the ruling position of the CCP, elites agree on the need for more pluralistic avenues for interest articulation and mechanisms to deal with social conflicts arising from a modern economy. While these ideas of political reform fall far short of electoral democracy, they are nevertheless an attempt to make the single-party regime more

36) Dali L. Yang, "Economic Transformation and Its Political Discontents", *Annual Review of Political Science*, 9 (2006): p.155.

37) Dali L. Yang, "Economic Transformation and Its Political Discontents", *Annual Review of Political Science*, 9 (2006): p.158; Mark Leonard, "China's New Intelligentsia", *Prospect Magazine*, 144 (March 2008).

attentive to social tensions and flexibly adapt to a more pluralistic socio-economic stratum.[38] The decline in influence of neo-liberal economic ideology in China in recent years and the rise of more public elite debate elite debate have important implications for the Chinese economy.

Implications of China's Socialist Market Economy

Under the current conditions of a global economic crisis and the decline of Chinese exports, it is unclear if the party-state will continue to privatize and downsize the SOE sector. Additionally, the lack of credit and fall of exports has hurt the private sector which fueled much of the economic growth in the last two decades. While the party-state is taking action to correct for the global economic crisis, in the short term we expect that the scarcity of credit, increasing unemployment, and declining exports will halt SOE reform, increase state intervention, and slow the expansion of private firms in the economy. Recently the Chinese economy appears to be rebounding faster than the US or EU zone. Although difficult to predict exactly how the crisis will impact China's socialist market economy in the long run, it is clear that growing unemployment and social instability will strengthen the calls of the new left for a social safety net and more government guidance in the economy.

Indeed, the general lack of a welfare state is a major factor constraining the evolution of the socialist market economy. Chinese citizens currently save 40 percent of their income and despite government stimulus programs, will not engage in consumer spending until they are no longer concerned about the expenses associated with health, education and retirement. As long as citizens bear the burden for these expenses individually, a consumer market will not expand and unemployment becomes a dominant factor for all future reform decisions of the party-state. In fact, the party-state estimates that the GDP must grow by over 8 percent annually to keep the unemployment rate at a manageable level. These factors constrain the evolution of the socialist market economy leading to the likely continuation of a large SOE and state-directed sector, and credit

starvation for the private sector. Moreover, low consumer spending will remain an important constraint on the ability of the party-state to move from an export-led model of growth to one based on its domestic market.

Thus all economic and political indications point toward greater emphasis on social equity and state intervention in the short term. Despite ongoing elite disagreement on the appropriate relationship between market and state, the current compromise version of the socialist market economy is likely to continue for some time. The incremental shift to the left in economic policy also has implications for the following issue areas:

1) **Foreign Investors:** Heavy state-intervention in key strategic sectors and pillar industries will continue to skew competition in these areas, with foreign firms facing continued discriminatory regulations. Low consumer spending will also restrict growth in the domestic market. Thus foreign companies and private enterprises will continue to be at a strategic disadvantage for some time to come.

On a positive note, institutional reforms to build rule of law and independent conflict resolution mechanisms, coupled with the passage of landmark property rights legislation may help to better protect foreign and private property. However, the development of more rule of law in China remains a long-term project.

2) **Private Firms in China:** Given that SMEs generally operate outside of the official banking system, it may be difficult for many of them to gain the capital to weather the economic crisis. Large firms and pillar industries on the other hand, have intensified their financial reliance on the state, raising western concerns of quasi-nationalization in key industries.[39] The result may be consolidation and a restructuring of the market in favor of larger firms rather than

38) John L. Thornton. "Long Time Coming: Prospects for Democracy in China", *Foreign Affairs*, Jan/Feb 2008.

39) "So Much for Capitalism", *The Economist*, March 5, 2009.

SMEs. Although party-state officials pledged to increase loans to SMEs, many banks such as Bank of China and China Construction Bank say that they intend to keep lending rates to SMEs to levels similar to last year.[40]

3) **Banking and Securities:** While new banking regulations seem to have significantly improved the risk-management of banks, many concerns remain regarding the level of non-performing loans (NPLs), particularly in the large state-owned banks that are often forced to "lend" to SOEs. Estimates of the level of NPLs vary wildly largely due to large write-offs and relatively opaque accounting procedures. The official state banking regulatory commission estimated the percentage of NPLs in commercial banks at about 7 percent at the end of 2007, but many foreign observers have suggested that these figures significantly underestimate the total percentage, which could be as high as 25–40 percent.[41] More importantly, there are concerns about the rise of bad assets following the extremely loose lending practices during the stimulus package earlier this year.[42] Efforts have been underway to clean up the books of these banks by allowing them to write-off bad loans, privatizing banks or allowing foreign banks to buy 25 percent stakes. While this may continue, the party-state will almost certainly retain a large state-owned component of the banking sector.[43]

In terms of equity markets in Shanghai and Shenzhen, SMEs once again face discriminatory financial policies, because most listed firms are SOEs. Even companies listed on stock market as private companies actually have high levels of hidden government investment and control. This system has created a somewhat perverse incentive structure from a neo-liberal perspective, as prospects for heavier state intervention in a company often lead to an improvement in share price.[44]

4) **Exports and Product Sourcing:** In the wake of numerous recent product safety scandals the party-state increased funding and monitoring of safety regulations. However large obstacles remain to enforcing stronger regulations, such as a lack of regulatory independence and a highly fragmented market structure, with hundreds

if not thousands of firms operating in an industry such as pharmaceuticals. Such fragmentation raises questions about state-regulatory capacity.

Before the economic crisis China was in the process of phasing out the preferential tax policies designed to attract foreign investment. This was part of a broad strategy to shift away from heavy reliance on export-led growth, to a more balanced model of growth. The economic crisis has largely halted this process, as the state cannot afford to continue to reform its primary engine of growth.

5) **Political Reform:** Clearly the transition to a market economy requires a new set of market-supporting institutions, generally grouped under the concept of rule of law. Efforts by entrepreneurs and peasant groups advocating for their interests finally led to a landmark property-rights law, although the implementation of that law remains contested. Most elite discourse on political reform in China falls far short of what is perceived to be a messy process of electoral democracy. Instead, most discussions of political reform focus on a professional and more independent judiciary that can serve as an important conflict resolution mechanism.

40) George Chen and Michael Wei, "China to Offer More Loans to Smaller Enterprises", *Reuters*, March 6, 2009, website accessed at http://www.reuters.com on June 16, 2009.

41) China Banking Regulatory Commission, "NPLs of Commerical Banks as of end of 2007", website accessed August 20, 2009; Qiang Liao, "Estimate of Chinese Bank's Gross Problematic Assets Lowered to 25–40%", *S&P Credit Research*, Standard and Poor's, August 5, 2009; Jonathan Richter, "Circumscribing China's NPL 'Puzzle'", *Wharton Research Scholars Journal*, April 28, 2008; Nicholas R. Lardy, "The Challenge of Bank Restructuring in China", in *Strengthening the Banking System in China: Issues and Experience*, Basel, Switzerland: Bank of International Settlements, 1999.

42) Prudence Ho and Stephen Aldred, "Chinese Banks Slow Pace of Lending", *Reuters*, August 21, 2009.

43) Shih argues that "the domination of the state in the financial sector continues beneath a series of cosmetic changes", see Victor Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China", *The China Quarterly* 184 (2004): p 943.

44) "So Much for Capitalism", *The Economist*, March 5, 2009.

In addition, the party-state has undertaken numerous governance reforms and local level experiments in the hopes of developing more responsiveness within the party-state to the variety of interests that have emerged in modern society. Before the global crisis, all indications were that the state was willing to give tacit approval to numerous local-level political experiments, the boldest and most notable of which were to take place in Shenzhen.[45] As with other reforms, the economic crisis has likely taken precedence over political reform as increased social instability and economic uncertainty is liable to diminish support for political liberalization. Nevertheless, this is likely to become an important area of attention when the global economy rebounds.

45) Edward Cody, "Pioneering Chinese City Offers a Peek at Political Ferment", *Washington Post*, June 30, 2008; Yang Xingyun, "Shenzhen Lays Ambitious Plans for Democratic Politics", *Economic Observer Online* 372, June 16, 2008: 17.

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