

MŰHELYTANULMÁNYOK

DISCUSSION PAPERS

MT–DP. 2004/10

**ARE SPECIFICS OF THE CHINESE  
TRANSFORMATION SUFFICIENT  
TO AVOID SYSTEM DEMISE?**

MÁRIA CSANÁDI

Institute of Economics  
Hungarian Academy of Sciences

Budapest

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**Are specifics of the Chinese transformation sufficient to avoid system demise?**

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**ARE SPECIFICS OF THE CHINESE TRANSFORMATION  
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BY MÁRIA CSANÁDI

***Abstract***

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*Extensive comparative literature deals with the extraordinary economic development in China, and tries to find the factors of this rise compared to the precipitous economic decline of the East European party-states. Does the Chinese system have different basic characteristics than its counterparts in Eastern Europe? What are its specific traits that explain its particular operation and transformation? Are these sufficient to avoid systemic demise? The paper offers answers to these questions through the introduction of a comparative party-state model. Based on the analysis of the empirical material the model predicts that China might avoid similar collapse as in Eastern Europe and the Soviet Union but will not avoid system demise. This latter however, due to the growth of the private sphere, will probably be smoother, partially advancing and gradual.*

*Key words: China, comparative model, reforms, party-state structure, collapse, transformation*

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DISCUSSION PAPERS

MT–DP. 2004/10

CSANÁDI MÁRIA

**ELEGENDŐEK -E A KÍNAI ÁTALAKULÁS SAJÁTOSSAGAI A  
RENDSZERÖSSZEOMLÁS ELKERÜLÉSÉHEZ?**

***Összefoglalás***

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*Széleskörű összehasonlító irodalom foglalkozik Kína rendkívüli gazdasági fejlődésével és megkísérli feltárni e növekedés tényezőit, szemben azzal a zuhanásszerű gazdasági hanyatlással, amelyet a kelet-európai pártállamoknál tapasztaltak. Vajon a kínai rendszer alapvető jellemzői eltérőek-e a kelet-európaiakétól? Ha nem, akkor mik azok a specifikus vonások, amelyek sajátos működését és átalakulását magyarázzák? A cikk egy összehasonlító analitikus modell bevezetésével igyekszik a fenti kérdésekre válaszolni. Az empirikus anyagok elemzése alapján a modell előrejelzése szerint Kína el tudja kerülni a kelet-európai és a szovjet jellegű összeomlást, de magát a rendszer felszámolódását nem. Ez utóbbi azonban, a magánszektor gyors növekedésének kompenzáló hatása, valamint strukturális okok miatt, a kelet-európaiakéhoz képest jóval tompítottabb, részlegesen és fokozatosan előrehaladó lesz.*

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## INTRODUCTION

Extensive comparative literature deals with the extraordinary economic development in China, and tries to find the factors of this rise compared to the precipitous economic decline of the East European party-states. Does the Chinese system have different basic characteristics than its counterparts in Eastern Europe? What are its specific traits that explain its particular operation and transformation? Are these sufficient to avoid similar systemic demise? The paper offers answers to these questions through the introduction of a comparative party-state model. This model sheds light on the self-similarities and specifics of the party-state structure, defining three characteristic patterns of power distribution that implies specific paths of self-reproduction and transformation. It locates China in one of these patterns according to its specific distribution of power that simultaneously defines the location, pace, sequence of reforms and the regime under which these are implemented. Structural conditions also constrain the room for maneuver in choosing reform strategies. We also empirically reveal how reforms placed in the structural and dynamic context of power distribution will contribute to the systemic self-destruction during self-reproduction of the Chinese party-state, in terms that economic growth is paired with the disintegration and withdrawal of the party-state network. Based on the predictions of the model after analyzing the empirical material we conclude that China might avoid similar collapse as in Eastern Europe and the Soviet Union but will not avoid system demise. This latter however, due to the growth of the private sphere will probably be smoother, partially advancing and gradual.

## THE STUCTURE AND DYNAMICS OF PARTY-STATES

The Interactive Party-state (IPS) model is an inductively built dynamic construct that is based on more than twenty-eight years of empirical research of economic policy decisions and their institutional consequences in Hungary. Theoretical results were *extended* to the structure and operation of the Soviet- and East-European and Chinese party-states. The IPS model is an explanatory device for interpreting the operation and transformation of any communist party-state<sup>1</sup>. Interactivity is central to the model because it

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<sup>1</sup> The detailed description of the model may be found in Maria Csanádi, *Party-states and their Legacies in Post-communist Transformation*. (Edward Elgar, Cheltenham, UK, Northampton, Ma, US, 1997); Maria Csanádi, *A comparative Model of Party-states:*



concentrates on the inner workings of the party-state and highlights the interaction of individual and institutional interests and behavior defined by a characteristic structural setting. The model postulates a self-similar<sup>2</sup> character for the structure and operation of party-states along different dimensions. It also identifies the structural reasons behind the differences among party-states.

The distinctiveness of a party-state structure evolves through the direct connections between party and state, politics and the state-owned economy. Direct connections arise via the power instruments of the party (*Figure 1*).

We call these instruments as interlinking dependency lines<sup>3</sup> (D<sub>2</sub>). These inter-linking lines penetrate non-party institutions<sup>4</sup> and directly influence decisions by overlapping positional-, organizational-, activity structure and individual behavior. These specifics render the political nature of dependencies and interest promotion possibilities for those connected to these lines. Inter-linking lines produce structurally built-in inequalities among those connected and those lacking connection. It makes also possible the deeper political integration of strategic actors that – by meeting priority criteria of politically rational concerns – are able to short cut the decision-making process within and across party and state hierarchies at any level. With short cuts another structurally built in inequality will emerge. Through shortcuts actors are able to directly promote their interest and resist to disadvantageous decisions by encountering decision-makers whom otherwise, considering their formal position in the hierarchy would never

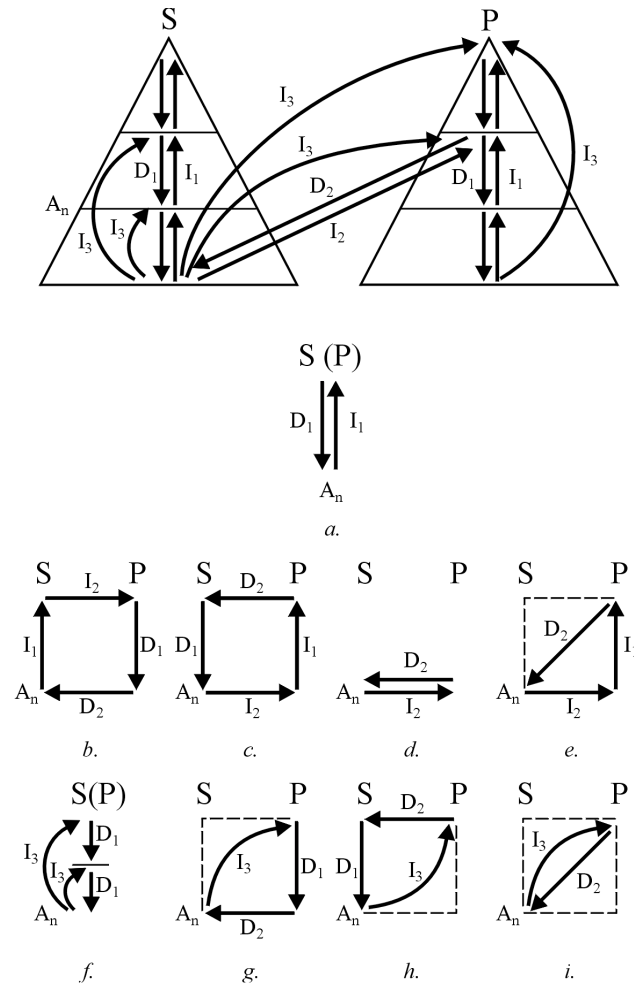
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*Structural background of Similarities and Differences in Reproduction, Reforms, Collapse and Transformation* (Manuscript, Budapest, 2003).

<sup>2</sup> See Maria Csanádi and Andras Lörincz 'Neural Network Formalization of the Hungarian Party-state System', *Behavioral Science*, Vol. 37, N2, 1992, pp. 81–108.

<sup>3</sup> The interlinking lines infiltrating the institutional framework of non-party institutions are the following: the nomenklatura system overlapping decisions through position structure in non-party organizations, the subject-matter responsibility system overlapping decisions through activity structure, the instructor system, overlapping decisions through the organization structure, the party membership, overlapping individuals through party discipline (Csanádi, *Party-states*, 1997).

<sup>4</sup> Not only the state owned economy is directly connected to the party. The same direct connection is true for other sub-spheres and levels of the society: culture, politics, education, healthcare, civil society, social movements, mass movements, executive legal and judicial decisions, procurator, police apparatus, etc. These sub-spheres for the sake of simplicity are "condensed" in the concept of the non-party – state – hierarchy.



**Key:**

- S State (non-party) hierarchy
- P Party hierarchy
- $A_n$  Decision-makers (actors) at the  $n^{\text{th}}$  level of the structure
- $D_1$  Direction of intra-hierarchy dependence
- $D_2$  Direction of cross-hierarchy dependence
- $I_1$  Path of intra-hierarchy interest promotion
- $I_2$  Path of cross-hierarchy interest promotion
- $I_3$  Direction of feedbacks

**Figure 1** Power structure of the party-state system and the perspective of decision makers (actors,  $A_n$ ) on various levels on the possible paths of interest promotion (from 'a' to 'i').

meet<sup>5</sup>. For using hierarchical and interlinking lines as loops to feed back promoted decisions, shortcuts are a form of structural feedback<sup>6</sup>.

The result of unequal interest promotion and resistance possibilities is that bargaining capacities and formal positions differ. These characteristics furnish the unique institutional interactivity of politics and other spheres at the level of individual decision-making. They comprise the structural background of operating principles of party-states: the politically monopolized dependencies, politically monopolized interest promotion, as well as the politically monopolized resource extraction and redistribution. They also contribute to the politically rational motivation and subsequent behavior of actors that are being *simultaneously exposed to and holding* dependency lines within the structure concerning intervention, selection and interest promotion and resistance to intervention.

The different bargaining capacities of actors simultaneously captured by and holding dependency lines emerge from built-in inequalities due to the distribution of inter-linking lines, feedback mechanisms and the unequal distribution of resource-extracting capacities. These inequalities result in different resource attracting, extracting, distribution and resisting capacities of the actors within the net exposed and holding dependency lines. The balance of these capacities will conclude in selectively hard or soft reproduction constraints that, by defining the distribution of power within the system, forge the dynamics of the structure, motivating actors' behaviour.

Elements, principles of connection of these elements, the principles of operation and the subsequent motivations and behaviour have a self-similar pattern. This self-similarity will prevail no matter the time, the space, the levels of aggregation and the conditions of the structure<sup>7</sup>. Differences emerge within the self-similar properties due to the different distribution of the origin, extent and depth of inter-linking threads, locus of origin, level and place of arrival and density of feedbacks acquired and the different distribution of resource extraction and allocation capacities<sup>8</sup>. The

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<sup>5</sup> For example it may occur within the hierarchies: if an enterprise manager is invited to a ministerial session, or a local party secretary becomes member of the Central Committee of the Party (CC), or across hierarchies: if an enterprise manager or local government leader becomes member of the CC.

<sup>6</sup> See the structural feedback in detail Csanádi *Party-states*, pp. 28–37.

<sup>7</sup> This is the reason why we can use this model as an analytical tool at any aggregation level of the party-state structure.

<sup>8</sup> The variation of structural elements: inter-linking lines may vary in density, extension and depth, shortcuts may vary in density, level of accumulation, the place of those in

combination of these differences will define the *different distributions of power* and accordingly the differences in the distribution of those actors with soft or hard reproduction constraints. Soft and hard reproduction constraints are selective according to structural specifics. The distribution of the selectivity changes according to the dynamics of reproduction of the structure at different aggregations and conditions. Based on the above arguments we shall use reproduction constraints as an *extended version of budget constraints* nested in power relations. In this context, reproduction constraint is a structural rather than an economic term, it is selectively soft according to the distribution of power rather than soft in general. It is based on the extracting, attracting, allocating and resisting capacity of the unit within the given power relation. Softness or hardness of reproduction constraints concerns self-similar units, not only state-owned enterprises. Softness or hardness may vary in time, in space and different aggregation levels and conditions of the structure. Reproduction constraints strongly interact with budget constraints that emerge in the relationship of the net to the environment external to the net. The impact of budget constraints on the reproduction of the party-state network varies according to the combination of hardness and softness of reproduction and budget constraints. Status quo within the net is preserved if budget constraints are soft, adaptation pressures increase and cohesion of the net declines if reproduction constraints and budget constraints become simultaneously persistently hard.

### **THE MAIN PATTERNS OF REPRODUCTION AND TRANSFORMATION**

The structure, operation and transformation of party-states may be grouped from the point of view of reproduction of the system, according to the specifics of the distribution of power and its adequate dynamics (Table 1). Distribution of power includes three major structural factors: (1) the distribution of inter-linking threads, (2) the existence of structural feedbacks (shortcuts) from economic field and (3) the levels of extraction and allocation of resources.

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the respective hierarchy who are privileged by short-cuts and the place (within his/her own or party hierarchy) where the privileged actor reaches as a consequence of the short-cut, and extracting and allocating capacity may vary according to which level they are delegated or concentrated in the structure.

**Table 1: Basic patterns of power distribution in party-states and adequate reproductions and transformations**

<b>PATTERNS OF REPRODUCTION</b>	<b>SELF-EXPLOITING</b>	<b>SELF-DISINTEGRATING</b>	<b>SELF-WITHDRAWING</b>
Distribution of power	Centralized extraction and redistribution and centralized inter-linking threads with no (scarce) economic feedbacks	Centralized extraction and redistribution, centralized (or decentralized) inter-linking threads with economic feedbacks	Partially decentralized extraction and redistribution and either centralized or decentralized inter-linking threads with economic feedbacks
Relationship between units and sub-units	Faint resisting and attracting capacity of sub-units	Selectively strong attracting (resisting) capacity of sub-units	Selectively strong resisting (attracting) capacity of sub-units
Reproduction constraints	Reproduction constraint on unit level is RARELY HARD as a consequence of unconstrained extracting capacity	REPRODUCTION constraints on unit level become OCCASIONALLY HARD within the net when there are no more resources to extract in the given distribution of power	REPRODUCTION constraints (p) on unit level become FREQUENTLY HARD within the net as a consequence of the unit's faint extracting capacity
Mode of resource acquisition	Forced resource redeployment within the net (no reforms), redistribution based on political rationality	Drive to mobilize resources to extract within the net (resource mobilizing reforms) while fixed paths of redistribution based on political rationality prevail within the net	Drive to create resources to extract outside the net (resource creating reforms), while fixed paths of redistribution based on political rationality prevail within the net
Economic development	Forced economic growth based on political priorities while economically undermining the system	Economic recession due to soft budget constraints of those privileged within the net while reform escalation due to growing frequency of hardening budget constraints in the capacity to mobilize further resources on unit level	Economic growth due to hard budget constraints of those outside the net and reform escalation due to persistently hardening budget constraints within the net on unit level
Condition of the net	Remains unharmed	Emptying – for the lack of resources; deteriorating capacity to overlap positional, activity and organizational structure, decentralization of inter-linking threads for better local control and to get rid of burdening responsibilities	Relative and absolute shrinking and emptying; deteriorating capacity to overlap of positional, activity and organizational structure, decentralization of inter-linking threads for better local control and get rid of responsibilities
Sequence of transformation	(1) Abrupt collapse (2) Disintegration parallel to Transformation	(1) Disintegration (2) mild collapse (3) Transformation	(1) Disintegration parallel to Transformation (2) Advancing partial and delayed system collapse

Three major patterns are given upon the variation of the above elements: (i) Self-exploiting, (ii) Self-disintegrating and (iii) Self-withdrawing patterns.

These structural factors will determine the different *frequency* of hardening reproduction constraint within each pattern, according to its specifics of resisting and attracting capacity of actors within the net. The larger is the resisting and attracting capacity within the net the more frequently will the self-reproduction run into resource constraints and loss of cohesion in the given distribution of power. Accordingly, the frequency of hardening reproduction constraint is the lowest in the Self-exploiting pattern and the highest is in the Self-withdrawing pattern. These structural patterns will also determine the possible measures for resource extraction and distribution to restore cohesion and thereby the different ways of self-reproduction. Measures vary from forced resource redeployment, through resource mobilizing reforms to resource creating reforms respectively. Conversely, the impact of the specific way of self-reproduction on the structure results in characteristic self-destruction: growing tensions, disintegration, collapse and transformation. Disintegration, collapse and transformation will occur in different sequence and pace according to the specifics of the pattern of power distribution: in the Self-exploiting pattern no disintegration will occur before collapse and this latter will be abrupt. In the Self-disintegrating pattern disintegration will be uninterrupted and collapse will be smooth, and political transformation is the first. In the Self-withdrawing pattern disintegration is also continuous and economic transformation will be the first, parallel to disintegration, while system demise will be partial and spreading.

#### WHICH PATTERN CHINA IS SUPPOSEDLY BELONGING TO?

As a complex aggregated structure, the PRC seems to follow the Self-withdrawing pattern as opposed to the East European countries that pertain to either the Self-exploiting or Self-disintegrating patterns. This supposition is supported by several factors regarding the Chinese structure and dynamics. First of all, this is suggested by the characteristics of the *distribution of power* in China. Since overwhelming and growing number of state owned enterprises (SOEs) are delegated to the subordination of different level local authorities<sup>9</sup>, many interlinking threads (e.g. the nomen-

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<sup>9</sup> So are the resources from township and village enterprises and most part of the taxes of private enterprises.

klatura responsibility) are distributed akin. This also involves the relatively decentralized discretion to extract resources at local levels that allows for the lower degree of exposure of local authorities and economic units to central distribution. It also implies the larger capacity of local authorities to resist disadvantageous interventions by the central authorities. The existence of structural feedbacks is suggested at first glance by the selected group of strategic state owned enterprises (SOEs) subordinated to the party's highest forums both at central and local levels, the membership of selected SOE managers in the Party's Central Committee and the membership of selected provincial party committee secretaries in the CCP's Politburo. The relatively decentralized interlinking threads and resource extracting capacities and strong selective feedbacks suggest stronger resisting and attracting capacities within the net.

These structural characteristics anticipate the *characteristic dynamics* of Self-withdrawing pattern during the self-reproduction of the structure: the frequency and success of further decentralizing reforms, the frequent failure of centralizing reforms, the drive to create new resources outside the net and the gradual disintegration of the power network as a consequence of decentralizing reforms. In this respect, the Chinese economic policy developments and its consequences predict the relative and absolute shrinking of the net. Regarding the *relative* shrinkage, in other words, the expansion of the field outside the net, a fast growing share may be experienced in the number, employment, production and tax contribution of non-state enterprises outside the party-state's influence. Moreover, a large and continuous increase in foreign and domestic private capital is registered infiltrating the party-state network through the formation of joint ventures and purchasing shares in transformed SOEs. Regarding the *absolute* shrinkage of the net, that is, the waning of its elements, we can experience similar phenomena. A fast growing number of county, and township and village level governments developed growing budget deficits. These developments have resulted in the boost of TVE and SOE privatization subordinated to them<sup>10</sup> in order to get rid of burdens. For similar reasons, one can detect a continuous withdrawal and deterioration of state functions and that of the

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<sup>10</sup> Yang Yao 'Government Commitment and the Outcome of Privatization in China', <http://www.usc.cuhk.edu.hk/webmanager/admin/pdf/003.pdf>, China Center for Economic Research, Beijing University, 2003; Maria Csanádi and Hairong Lai 'The Transformation of the Chinese Party-state on National, Prefecture and County Levels', Working Papers, Institute of Economics, Hungarian Academy of Sciences, Beijing-Budapest, 2003

organizations of state intervention in the economy and an increasing number of village, township and county level free-and semi-free elections that have redistributed responsibilities towards the society<sup>11</sup>.

Due to the growing share of FDI in SOEs, the privatization, the decline of resources to mediate within the network, as well as the redistribution of responsibilities and burdens, the party's power weakens as its interlinking lines weaken, empty, or are withdrawn or cut at several levels. These developments suggest the disintegration and transformation of the elements of the system at different levels and thereby the partial and spreading demise of the system. The relative and absolute shrinking of the party-state's net, its accelerating disintegration, the withdrawal and decline of hierarchical functions and organizations and interlinking lines, as well as the growing extent of activities outside the party's influence point to the characteristics of the Self-withdrawing pattern: disintegration, parallel to transformation and partial-spreading collapse. Similarly, the primacy of economic transformation in China as opposed to that of the political transformation in Eastern European party-states also scores China to the characteristics of the Self-withdrawing pattern. The above structural and dynamic characteristics explain the differences in the characteristics of the transformation of China accompanied by economic growth and the East-European and Soviet party-states pertaining to the Self-exploiting and Self-disintegrating patterns accompanied by economic crisis.

In the following sections we shall detail the concrete developments in China in view of the dynamics of the Self-withdrawing pattern. We shall start from the early 1990s, the stage when the main pattern characteristics became more visible in the process of self-reproduction of the net both at central and local levels. This was first related to economic policy measures reacting to structural constraints and later to the consequences of competitive pressures, domestic and international, from outside the net.

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<sup>11</sup> Hairong Lai, 'Development of Competitive Elections since mid 1990s on Township Level in Sichuan Province in China', *China Perspectives*, Vol. 51, 2004, Hong Kong, pp.13–27.



## THE ACCELERATION OF THE SELF-WITHDRAWAL OF THE PARTY-STATE NETWORK IN CHINA

### LETTING THE NET SHRINK OFFICIALLY

The acceleration of the characteristic process was due to several economic policy factors. Such was first of all, Deng Xiaoping's domestic roundtrip that was meant to revive growth after the retrenchment period through township and village enterprises (TVEs) and private ventures. His action was formalized on the 14<sup>th</sup> Party Congress in 1992, when the Congress declared the existence of the socialist market economy, and the legitimacy of private ownership was included in the party statute. The next year, the legitimacy of private ownership was also legally recognized, as Peoples' Congress included the acknowledgement of private ownership in the Constitution. By those moves, the obstacles to the relative shrinkage of the net were officially repealed. Besides stimulating the activity of TVEs and private entrepreneurs also economic activity in general was given an impetus, since the 14<sup>th</sup> Party Congress had formally jettisoned the central plan as a mechanism for resource allocation, giving way to other measures. By that time, the proportion of planned production in the total industrial output value was reduced from over 90 percent in 1978 to 5 percent in 1993.<sup>12</sup>

Administrative boundaries of economic activity were replaced by a differentiated legal framework. A Contract Responsibility System regarding SOEs was enhanced by the Regulations on Transforming the Management Mechanism of State-Owned Industrial Enterprises and more autonomy was delegated to SOEs on several fields. The law defined three major forms of companies: joint-stock company, Limited Liability Company and wholly state owned company. Besides the recognition of joint-stock companies, the perspective on the infiltration of foreign and domestic capital into SOEs was given also in another form, though inexplicit, by the resolution of the 3<sup>rd</sup> plenum of the 14<sup>th</sup> Party Congress in 1993. According to the resolution, every SOE were to be turned into company. Around 10,000 enterprises were to be transformed into corporations, restructured or merged.<sup>13</sup> In the first

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<sup>12</sup> Wing, Thye Woo, 'Why China Grew' in *Emerging from Communism: Lessons from Russia, China, and Eastern Europe* ed. Boone, Peter, Stanislaw Gomulka and Richard Layard, MIT Press Cambridge, MA, London, 1998 pp. 153–182, at p.158.

<sup>13</sup> Laixang Sun, 'Emergence of Unorthodox Ownership and Governance Structures in East Asia. An Alternative Transition Path'. Research for Action 38 UNU World Institute for Development Economics Research (UNU/WIDER) 1997, pp. 1–35, at pp. 22–23.

instance, the shares in centrally controlled SOEs were to be held by the state. However, the intention was to distribute the shares gradually to provincial and local governments and banks. Operations were delegated to the management, who in turn bore responsibility for profits and losses.

Also privatization was given an official impulse. At a plenum in 1993, the Chinese Peoples' Congress (CPC) had identified "ambiguous property rights" as a key reason for the inefficiency of SOEs<sup>14</sup>. The Plenary Session of the 14<sup>th</sup> Party Congress adopted a document on economic system reforms. It did not advocate privatization, but it left the door slightly open for the process. As for the small state-owned enterprises, it stressed that the management of some can be contracted out or leased. Others can be shifted to the partnership system in the form of stock sharing, or sold to collectives or individuals<sup>15</sup>.

However, by the time privatization was legalized and politically legitimized, the process has already started: for example, Zhucheng city in Shandong province, started privatizing SOEs in 1992, when two-thirds of its SOEs were losing money or just breaking even. Almost 90 percent of county-supervised SOEs in Zhucheng have already been privatized. Sichuan province was steadily selling off money losing SOEs, and Guangdong province was selling profitable SOEs as well, in order to finance local infrastructure and to clear the debts of unprofitable SOEs before putting them up for sale. Heilongjiang province had announced plans to privatize 200 SOEs after having sold 160 successfully<sup>16</sup>.

By allowing officially the purchase of smaller SOEs, and legalizing joint-stock and limited liability companies the Party had willingly or unwillingly a complex impact on local behavior. It allowed local governments to get rid of unprofitable burdensome enterprises while in turn they acquired some resources for the conservation of the remaining net through domestic or foreign private capital<sup>17</sup>.

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<sup>14</sup> Woo, 'Why China Grew', p. 155.

<sup>15</sup> *China Daily*, Supplement, Nov 17 1993; Yuanzheng Cao, Yingyi Qian and Barry Weingast, 'From Federalism, Chinese Style to Privatization, Chinese Style', 1999 *Economics of Transformation* Vol. 7 (1) pp. 103–131., at p. 120.)

<sup>16</sup> Woo, 'Why China Grew', p. 180.

<sup>17</sup> Privatization took several forms, many times they practically meant the technical transfer of the property to the workers without effective purchase (Lin, C. Z.: 'Open-Ended Economic Reform in China'. In: Victor Nee and David Stark (eds.): *Remaking the Economic Institutions of Socialism. China and Eastern Europe* (Stanford, CA., Stanford University Press, 1989) pp. 95–136, at p. 113).

Parallel to political opening and spreading privatization, FDI inflow also increased dramatically, partly entering the net through joint ventures and share-holdings, partly increasing the field outside the net through green-field investments. From 1991 to 1993, the number of projects increased six-fold, contractual value increased tenfold and realized value increased also six-fold. From 1993, the number of projects and contractual value declined but the realized value increased steadily. FDI inflow in fixed assets doubled from 1992 to 1993 and so did FDI's share in total investment in fixed assets<sup>18</sup>. Foreign investments at that period were invariably concentrated on the coastal region and were overwhelmingly performed by overseas Chinese in forms of joint ventures and collective enterprises with local counterparts<sup>19</sup>.

#### HARDENING REPRODUCTION CONSTRAINTS WITHIN THE NET AND CENTRALIZATION EFFORTS

Despite the increase of the field outside the net, reproduction constraints within the net further hardened. Consequently, revenue centralization efforts re-emerged. These efforts went parallel to the decentralization of expenses and increasing economic liberalization. In 1994 a major general *tax reform* was introduced. The new tax reform redistributed revenues within the net. It introduced central, local and shared tax revenues and items to be taxed. It also decreased SOEs' tax contributions to the level of other type of enterprises which was disadvantageous to the local governments supervising them<sup>20</sup>.

The definition of the local and central discretion for tax revenues was paired with strong political pressure for the institutional redistribution of power towards the centre<sup>21</sup>. These efforts were supported by several

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<sup>18</sup> Xiaojuan, Jiang, *The Impacts of WTO Accession in the New Regional Patterns of Trade and Foreign Investment in China* Manuscript, Institute of Finance and Trade Economics, Chinese Academy of Social Sciences, 2001, at p. 4.

<sup>19</sup> Xiaojuan, 'The Impacts of WTO Accession' 2001, pp. 1–3 *Table 1, Table 3*).

<sup>20</sup> Christine Wong, 'China National Development and Sub-national Finance. A Review of Provincial Expenditures', Report No. 22951-CHA, April 9, 2002, at p. 51, *Table 4.1*

<sup>21</sup> Christine Wong, 'China National Development'; John P. Burns, 'Strengthening Central CCP Control of Leadership Selection: The 1990 Nomenklatura', *China Quarterly*, 1994, Vol 139, pp. 692–722; Burns, 1994, pp. 470–471; Li Keping and Xiang Zhongxin *Intergovernmental Financial Distribution Relations in China: a Case Study*, Beijing, Manuscript, 2002 at p. 11; Andrew Wedeman, 'Budgets, Extra-budgets, and Small Treasuries: illegal monies and local autonomy in China', *Journal of Contemporary China*, 9(25), 2000; pp. 489–511.

complementary resolutions to ease the redirection of resource extracting capacity towards the centre. For example,

- (i) The *redistribution of the local interlinking threads* of resource-providers to the advantage of the centre: the nomenklatura of the leaders of local branches of specialized banks was re-centralized and so was monetary authority. The central bank has refused to accommodate monetary policy to the local government's behavior<sup>22</sup>. The central bank set up new regional network from 1995, delegating personnel decisions to the regional organization instead to local government<sup>23</sup>. The commercial banks' party secretary and management became subordinated to the central Financial Party Committee subordinated to the Politburo 1997. As a result, a nation-wide credit crunch was imposed and inflation has declined drastically, from over 20 percent to about 2 percent in 1997<sup>24</sup>
- (ii) Another resolution was deemed to *institutionally secure* the resource extraction by setting up at all levels local tax offices of the Central Tax Bureau for collecting to-be-shared and central taxes separately from local taxes.
- (iii) Also *one-off resource extractions* ensured the prompt redistribution of resources towards the centre. In 1993 and 1995, as another from the repeated central crackdowns since the mid 1980s, a full-scale crack-down campaign was carried out that for a short period substantially reduced illegal revenues and extra-budgetary funds<sup>25</sup>.
- (iv) *Institutional constraints* were introduced to inhibit uncontrolled deficit-financing of local governments to limit local investments. In 1995, local governments were required to have their budgets balanced, a law strictly controlled their bond issues and restricted borrowing in the fi-

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<sup>22</sup> Before this measure 70 percent of central bank loans were made by its local branches (Cao et al. 'From Federalism', at p. 117).

<sup>23</sup> Wong, 'China National Development', p. 175

<sup>24</sup> Yingyi Qian, Yingyi and Gerald Roland: 'Federalism and Soft Budget Constraint', *The American Economic Review*, Vol.88, 5, 1998, pp. 1143– 1162, at p. 1157; Cao et al., , 'From Federalism', p. 117). This centralization went parallel to the introduction of several monetary institutions, enhancing the rule of law: In 1995, People's Bank of China Law, empowering it to supervise and regulate the financial services industry; Commercial Bank Law; Insurance Law; Securities Law; Trust Law; Foreign Exchange Management Law; Township and Village Enterprise Law, 1996.

<sup>25</sup> These uncontrolled or loosely controlled moneys partly consisted of formerly authorised arbitrary fees of central and local institutions and government bureaux and were partly concealed sums. See Wedeman, 'Budgets, Extra-budgets', at pp. 494, 495, 506

financial market, and an independent State Auditing Agency was also introduced<sup>26</sup>.

As a result of the one-off revenue centralization, the share of the central authorities increased from 22 to 56 percent<sup>27</sup>. Meanwhile, the distribution of expenditures remained unchanged<sup>28</sup>. Thus, the tax and fiscal reform and additional measures in 1994 further hardened local governments' reproduction constraint.

The centralization efforts were selective according to different bargaining powers of the provinces. In order to ease the resistance of the provincial leaders at the introduction, fiscally compensating compromises, tax rebates were reached between the centre and the provinces. Consequently, measures that paved the way for the tax reform, simultaneously contributed to their formfitting to the given power distribution<sup>29</sup>. Formfitting according to power relations may be further revealed in the transitory success of power redistribution measures: local branches of central tax offices soon joined local interest network<sup>30</sup>.

Local governments' reproduction constraints became harder due to several factors – for example, as a result of the losses and indebtedness of subordinated SOEs, the increased constraints in reducing enterprise tax, the decreased capacity for exerting pressure for providing and selectively distribute credits, the loss of revenues as a consequence of the tax reform of 1994, the decreased central subsidies to SOEs<sup>31</sup>, the transferred subsidizing responsibilities from higher levels and the stable expenditure assignments despite revenue reallocation.

Hardening reproduction constraints were even more salient at sub-provincial levels. This was because there were no central regulations on the assignment of local taxes, nor concerning the redistribution of shared revenues and tax-

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<sup>26</sup> See Cao et al., 'From Federalism', at p. 116.

<sup>27</sup> See Wong 'China National Development' at p. 37.

<sup>28</sup> Li Keping and Xiang Zhongxin 'Intergovernmental Financial', at p. 11.

<sup>29</sup> See measures taken in Wong, 'China National Development' at pp. 34., 35., 71.)

<sup>30</sup> See Wong 'China National Development' at p. 82.

<sup>31</sup> The volume of explicit subsidies to SOEs did not increase parallel to the losses. Therefore, its ratio compared to losses declined steadily between 1986 and 1991 and so did the share of subsidies to loss-making state owned enterprises in the GDP (Jefferson, Garry H. and Thomas G. Rawski: 'Ownership Change in Chinese Industry', in: G. Jefferson and I. Singh (eds.): *Enterprise Reform in China: Ownership, Transition and Performance*, (World Bank Research Publication, Oxford University Press, 1998), pp. 23–42., at p. 35.).

rebates, or on the ways of rolling down expenditures to sub-provincial level. These as we suppose, varied according to the distribution of power within the province and at lower levels<sup>32</sup>. After 1994 fiscal resources were concentrated to the provinces<sup>33</sup> while expenditures were dispersed. This fact points to the limited attracting capacity in general of the sub-provincial levels<sup>34</sup>. Extra-budgetary funds – that derive from fees collected locally and run uncontrolled by upper levels – had a high rise after 1994 tax reform<sup>35</sup> supposedly, as an effort to compensate budgetary losses and fulfill local goals. After the tax reform also privatizations and closedowns have accelerated at lower levels and are steadily spreading to upper levels. The drive to get rid of the local SOEs may be attributed to their loss-making, to the decentralization of responsibilities for subsidizing them and to the hard burden these SOEs meant for the local budget<sup>36</sup>. As a reaction to growing burdens, local governments tried their best to hide resources from upper levels even in constrained conditions<sup>37</sup>. They also encouraged local enterprise to pursue short-term profit maximization, hide profits, secretly privatized SOE under their control, and tacitly encouraged spontaneous privatization or local revenues to go untaxed<sup>38</sup>.

The tendency of privatization as a solution to growing burdens was legitimized and encouraged by the central government: in mid 1995 that endorsed a slogan for SOEs on "grasping the large and letting go the small"<sup>39</sup>.

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<sup>32</sup> This assumption is underlined in Wong's book, who describes the sub-provincial distribution of revenues and expenditures and being subject of individual negotiations (Wong, 'China National Development', at p. 101). The difference in bargaining capacities among sub-provincial levels is reflected for example in the categorization of the provinces into three groups by Wong, according to the total, partial or no rolling down of tax-rebates received by the province (Wong, 'China National Development', at p. 77–78.).

<sup>33</sup> Wong, 'China National Development', at p. 46.

<sup>34</sup> Wong, 'China National Development', at p. 57.

<sup>35</sup> Wedeman 'Budgets, Extra-budgets', pp. 489–511; Wong, 'China National Development', at p. 101.

<sup>36</sup> Woo, 'Why China Grew', p. 155, State Council advisor in China, interview, 2000.

<sup>37</sup> Wedeman, 'Budgets, Extra-budgets' pp. 489–511.

<sup>38</sup> Qian, Yingyi: Enterprise Reform in China: Agency problems and Political Control. *Economics of Transition*, 4 (2), 1996, pp. 427–447., at p. 436.

<sup>39</sup> Cao, Qian, Weingast, 'From Federalism', p. 121.

# THE DECLINE OF GROWTH AND FURTHER HARDENING OF REPRODUCTION CONSTRAINTS WITHIN THE NET

By 1996, economic growth was *slowing down*: this did not only concern SOEs but also collective enterprises. Profit rate of collective enterprises (most of them rural): dropped from 26.5 percent in 1980 to 8.2 percent in 1996, while that of SOEs dropped from 24.9 to 6.5 respectively<sup>40</sup>. SOE decline had accelerated by 1996. After 18 years of gradual transformation the SOE share in China's total industrial output has declined from 77.7% in 19978 to 28.8% in 1996<sup>41</sup>. The share of employment in SOEs in 1996 was 57.4% of the urban workers. SOEs possessed 52.2% of total investment in industrial fixed assets. They were losing money, in spite of the large amounts of implicit subsidies from low interest loans and other policy protections (*Lin et al.*, 1998, p. 426). The share of subsidies to loss-making SOEs in the GDP from its 1985 height (5.66%) declined to 0.27% in 2001<sup>42</sup>. Overall, in 1996, 23 percent of the 390,000 enterprises reported losses<sup>43</sup>. According to Cao et al., 90 percent of loss-making enterprises were small. Losses in 1996 were suffered by 38 percent of SOEs, 40 percent of large and medium-size SOEs, 60 percent of small SOEs, 18 percent of collectives and 34 percent of "other" (share-holding and foreign invested) enterprises<sup>44</sup>. This tendency exerted further pressures to get rid of burdens.

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<sup>40</sup> Russel Smyth, 'Recent Developments in Rural Enterprise Reform in China: Achievements, Problems and Prospects', *Asian Survey*, Vol XXXVIII. N. 8., 1998, pp.784–800 at p. 785.

<sup>41</sup> Large scale SOE consisted 5.6 of SOE in terms of number in 1996, contributing 63.3% of the gross output value of the SOEs (Justin Yifu Lin, Cai, Fang and Zhou Li, 'Competition, Policy Burdens and State-Owned Enterprise Reform', *American Economic Review*, May 1998 (Papers and Proceedings), Vol. 88, No. 2, pp. 422–27, at p. 425).

<sup>42</sup> *Guoyouqiye Shichanghua Jincheng Yanjiu* (A Research on the Marketization of SOEs), by research team on the development of Chinese market economy, Institute of Economic and Resource Management, Beijing Normal University, 2002. *Source*: [http://www.snweb.com.cn/gb/people\\_daily/2002/12/14/f1214001.htm](http://www.snweb.com.cn/gb/people_daily/2002/12/14/f1214001.htm)

<sup>43</sup> Jefferson and Rawski, 'Ownership Change', p. 35

<sup>44</sup> Jefferson and Rawski, 'Ownership Change', p. 35; Cao et al., 'From Federalism', p. 122.

## THE ESCALATION OF THE ABSOLUTE SHRINKAGE OF THE NET AND THAT OF RESOURCE-CREATING REFORMS

### ACCELERATING PRIVATIZATION AND CLOSEDOWN

Hardening reproduction constraints accelerated the privatization process. Based on an investigation in 1996 on letting go the small SOEs, You and Wang stress that by mid 1996 Heilongjiang had completed the privatization of 91.4 percent, Shandong 65 percent, Hunan 60 percent, Jilin 56 percent and Anhui 39 percent of its small SOEs. According to another source (Institute of Economic System Reform, 1997) Jiangsu had completed about 50 percent by the end of 1996 and Henan started privatization in 1996 with plans to finish by the end of 1997<sup>45</sup>. By the end of 1996 up to 70 percent of the small enterprises had been privatized in pioneering provinces. Most counties moved from the experimentation stage to a promotional stage. Many provinces have completed the change of ownership in more than 50 percent of their small and medium sized SOEs on county level<sup>46</sup>. By 1996 some pioneering counties such as Yibin of Sichuan, Shunde of Guangdong, and Zucheng of Shandong had privatized almost all of the state-owned enterprises under local supervision. By 1997, most counties in the country had progressed to privatize more than half of the state-owned enterprises under local supervision<sup>47</sup>. By 2002 the number of SOEs halved compared to 1997 including close-downs, mergers and privatizations<sup>48</sup>. Unfortunately there are no aggregate data on privatization. We can estimate the scale only from the reduction of the number of small industrial SOEs. From 1995 to 2000, the number of small industrial SOEs dropped to its half, from 72,000 to 34,000. The difference is 38,000 that had been either privatized or liquidated, or merged<sup>49</sup>. Since increasing sized enterprises are in general subordinated to increasing rank of authority, and privatization is gradually reaching larger enterprises, privatization is *spreading upward*. This tendency is suggested by the comparison of the tables showing the rate of decline in the number of and employment in SOEs on province, prefecture and county levels in 2000

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<sup>45</sup> Cao et al., 'From Federalism', p. 109.

<sup>46</sup> Cao et. al, 'From Federalism', p.109.

<sup>47</sup> Qian-Roland, 'Federalism and Soft', p. 1157.

<sup>48</sup> Zhao Xiao, 'Competition, Public Choice and Privatization in China' CCER working Paper Series, 199025 Beijing University, 1999.

<sup>49</sup> World Bank Interview, 2002



compared to 1994<sup>50</sup>. Upward spreading is a relative term, since this tendency is smoothened by the cross tendency of decentralization of inefficient enterprises to lower levels from all levels, in order to get rid of burdens (see the decisions of the 16<sup>th</sup> Party Congress in 2002 on the decentralization of SOEs subordinated to the centre). Upward spreading of privatization is also smoothened by the parallel direction of siphoning off the discretion over efficient SOEs from lower to upper levels<sup>51</sup>.

Local authorities constrained by hardening reproduction conditions also accelerated lay off in subordinated SOEs. Between 1995 and 1997 local governments in China took the initiative to massively lay off excess workers from state owned enterprises. Lay-off was mostly organized at city level, privatization at county level<sup>52</sup>. More than 10 million workers lost their jobs in 1996, while 8,9 million were in compensation state. About 3,6 million found jobs 2,3 million went out from labor market, mostly in textiles, measurement instruments, coal, metallurgy, chemical, forestry, machinery and electronics<sup>53</sup>.

The years-long tendency of upward spreading privatization was formalized and officially accelerated on the 15<sup>th</sup> Party Congress in September 1997, where Ciang Co Minh declared that *state owned industry should be decreased*. He announced that China would be undertaking massive privatization of its SOE sector<sup>54</sup>. China would privatize 369,000 SOEs<sup>55</sup>. Official forecasts also reflected the same tendency. A report in the official China Securities in November 2000, citing a survey by the National Bureau of Statistics, predicted that SOEs would eventually withdraw from most industrial sectors, while the state would retain control over a few key areas. The recommendation was that the state should pull out of direct activity in 146 of the 196 industrial departments, including garments, textiles, food, beverages, daily consumer goods and electronics. The report suggests that the state relinquish its monopoly but maintain at least partial control over 35 sectors, including coal, iron and other major mineral resources, aerospace, new materials, computers, medicine, electronics,

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<sup>50</sup> Csanádi and Lai, 'The transformation of the Chinese' Appendix 16 and 18.

<sup>51</sup> Csanádi-Lai, 'The transformation of the Chinese'

<sup>52</sup> Qian-Roland, 'Federalism and Soft', p. 1157.

<sup>53</sup> Xiao-qiang Wang, *China's Price and Enterprise Reform*. (London, Mackmillan Press Ltd., 1998).

<sup>54</sup> Woo, 'Why China Grew' at p. 180.

<sup>55</sup> Woo, 'Why China Grew' p. 155.

petrochemicals and automobiles. A state monopoly should be retained in 15 sectors, including military industries and electricity output<sup>56</sup>

#### WEAKENING LINKAGES BY EMPTYING THE RIGID STRUCTURES

At the end of the interlinking and hierarchical lines not only close-downs and privatizations put an end to the concrete party and state functions but so did the emptying of the rigid structures. In other words, the transferring of state assets outside the net through asset stripping went steadily further. Already in December 1995, the State Administration of State Property reported that asset stripping in the SOE sector has been about 50 billion yuan (annually) since the early 1980s<sup>57</sup>. This process has accelerated to such an extent that the State Council formed a leading group under the direction of then Vice Premier Zhou Rongji to examine the issue. This is not a problem that is limited to joint stock and shareholding co-operatives. Assets are being drained through various avenues such as joint ventures, between state and non-state firms. In shareholding co-operatives it arises because there are many instances where local officials understated the true value of collective assets so that purchasers of shares, including themselves, could benefit at reduced costs<sup>58</sup>.

#### WEAKENING LINKAGES BY PRIVATES ENTERING THE NET

Not only cut offs through privatizations and emptying were shrinking and weakening the net but so did entries of private capital into the same. In joint ventures, Party secretaries are not allowed to sit in the board of directors as such. They potentially have a voice through the trade union, especially since the Party Secretary is often simultaneously the trade union leader<sup>59</sup>. In Guangdong and the Special Economic Zones had succeeded in eliminating Party influence or activity. By 1995, in Guangdong the Party was essentially absent from joint ventures<sup>60</sup>. Same process is occurring with the

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<sup>56</sup> 'The SOE restructuring accelerates' *Economist Intelligence Unit, a U.K.-based information provider, Chinaonline* 6 December 2000).

<sup>57</sup> Woo, 'Why China Grew' at p. 177. The author refers to ('State Drain Must End' China Daily, Dec. 13, 1995, see also "State Toughens Stand to Protect Its Possessions" China Daily, June 2, 1995; "Asset Checks Can Stop Fiddles" China Daily, June 7 1995; "Market Investigated for Losing State Assets", China Daily, June 2, 1995.

<sup>58</sup> Smyth, 'Recent Developments' at p. 798

<sup>59</sup> Margareth Pearson, *China's New Business Elite. The Political Consequences of Economic Reforms* (Berkeley, L. A. London, University of California Press, 1997 at p. 69).

<sup>60</sup> Pearson, *China's New* at p.70)

withdrawal of state shares in share holding companies<sup>61</sup>. Indirect data suggesting this tendency by mid 1990's foreign firms together with rural enterprises already accounted for more than half of China's industrial output<sup>62</sup>.

The increase of domestic and foreign private capital also exerted competition pressure, further accelerating the above dynamics (decentralization, absolute shrinkage and weakening) of the net. According to some experts, as a result, competition pressure on SOEs reached a new level. It had greater effects on SOEs supervised by local government than on those supervised by the central (underlying the idea of upward spreading privatization) because local SOEs are frequently in competitive industries where the non-state firms entered<sup>63</sup>. The competitive pressure from outside the net, the hardening reproduction constraints within the net, and as a reaction, combined with privatization, closedown, lay-off and the emptying the rigid structure, also brought about the weakening of the remaining interlinking threads that were connected to the economy.

Supposedly as a consequence of hardening reproduction constraints and the decentralization process as an accompanying tendency, the absolute shrinking of the net is taking place also in party and state hierarchies. Competitive elections on village level government begun in early 1990s, based on the Organic Law of the Village Committees passed in 1987, including candidate choices<sup>64</sup>. Moreover, despite explicitly opposite central instructions, as a perfect example for the self-withdrawal of the net, semi-competitive elections for government leadership and in some places to party leadership are being held since then on township and some at county level. These elections are organized by local level party committees at the instruction of higher level local party Organization Departments<sup>65</sup>. These solutions, just as the privatization, seem to be also spreading upwards, parallel to the spreading of hardening reproduction constraints, encouraged by the province in order to win over the confidence and resource contribution of the population in politically destabilizing economic situations.

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<sup>61</sup> 'Inside the New China' A Special Report. *Fortune* 1999, October 11. No.19. pp. 50–86.

<sup>62</sup> Cao et al, 'From Federalism', p. 119).

<sup>63</sup> Qian and Roland, 'Federalism and Soft', p. 1157

<sup>64</sup> Yanqi Tong, *Transitions from State Socialism. Economic and Political Change in Hungary and China* (London, Boulder, New York, Oxford, Rowman and Littlefield Publishers Inc., 1997), at p. 216)

<sup>65</sup> Lai, 'Development of Competitive'

# DESPITE WITHDRAWAL, CHARACTERISTICS PREVAIL WITHIN THE NET

Based on the above processes, we can stress that the adaptation to hardening reproduction constraints within the net promotes its *accelerated withdrawal*. It appears, however, that withdrawal, despite competition pressures, does not necessarily imply the change of rationality, behavior and priorities *within* the remaining net. Instead, what happens is the continuous narrowing of the circle of those privileged. The prevalence of political rationality and operating principles within the remaining net is suggested by several factors. The nomenklatura system prevails in the shrinking net, both concerning the state owned economy, the bureaucracy and financial fields<sup>66</sup>. Government orders suggest the pervasiveness of the characteristic – politically rational – selectivity in bailouts in the field of direct subsidies from fiscal authorities, in cheap credits from the state banking system, in policy loans from the central bank financed with money creation, in the replacement of indicative credit quotas with mandatory ones. Similarly, we can mention the strict restriction on the flow of funds outside the state-owned banks biased against private ventures, the lending to projects outside the credit plan, the use of administrative credit plan and centralization of the allocation through it, the mode local leaders (government, ministry and bank) are held individually responsible for credit plan fulfillment<sup>67</sup>. The increase and large share of extra- and off-budgetary revenues of local and central governments testifies to the prevailing extracting capacities through dependency lines. Feedbacks are still active, and new are being created in the case of strategically important enterprises. Foreign capital is still attracted by large enterprises that have efficient feedbacks<sup>68</sup> to make their way in the net. At lower levels, share-holding cooperatives have not reduced the power of local governments. Despite only partially owning shares, they still nominate the director<sup>69</sup>. Corruption is very

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<sup>66</sup> In order to prevent bank corruption the state intervenes and interferes and controls very deeply the banking process and the punishment is very severe. It controls money supply too and at every bank the PC has to play the leading role. The banks general manager and its deputy are nominated by a central financial PC subordinated to the State Council (World Bank Interview, 2002).

<sup>67</sup> World Bank interview, 2002, Loren Brandt and Xiaodong Zhu "Soft Budget Constraint and Inflation Cycles: a Positive Model of the Macro-dynamics in China During Transition' *Journal of Development Economics*, 2001 Vol. 64. No. 2, Apr. pp. 437–457, at p. 441.

<sup>68</sup> Sun, 'Emergence of Unorthodox', p. 26–27).

<sup>69</sup> Smyth, 1998 at pp. 797–798.)

high, also indirectly testifying for the prevalence of the importance of party and state feedbacks and advantages provided through it. Capital flight from SOEs during delayed bankruptcy procedure is taking place in collaboration with local courts (Chinaonline, 2002). Infiltration into the net still has its rewards: private enterprises still use "red cap" as a method to drain the privileges yet available within the net and to protect their business. Some successful private entrepreneurs joined the party and have been incorporated into ranks of the political elite. Those remaining outside the net are being regularly consulted by local cadres on major community issues<sup>70</sup>.

Moreover, dynamics within the net is the usual: the form-fitting process is still taking place according to structural characteristics. Since 1996–97 to present days, parallel to the growing instability in the reproduction of status quo, efforts may be detected to re-strengthen the Party's role in SOE's<sup>71</sup> and strengthening the Party's control over the strategic state property – especially large enterprises – while getting rid of liabilities<sup>72</sup>. Some measures to weaken administrative power are being still reversed and form-fitted. In 1998, 10 ministries were abolished, and also enterprises formerly created and owned by other ministries, military, police etc. were detached to decrease economic policy intervention in enterprise management. The vacuum of power however was soon filled, ending up in the redistribution of power towards the Party. A Large Enterprise Working Committee (LEWC) under the Politburo was set up. LEWC was responsible for appointments of the enterprise leadership. About 180 strategic enterprises were selected and subordinated to its nomenklatura function<sup>73</sup>. From within them, the leadership of a smaller number of even more important enterprises is nominated by the CC's Organization Department and appointed by the Politburo. Similar committees were set up on provincial and prefecture levels for strategically important SOEs subordinated to those levels.

LEWCs in theory do not fulfil economic policy function. However, in practice, feedbacks to LEWC and higher levels mean concentration of allocation and extraction capacities. These enterprises cannot be directly privatized, however they may go listed through their subsidiaries where they keep majority shares. They are taking part in central government's infrastructure de-

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<sup>70</sup> Tong, *Transitions from State*, at p. 216.

<sup>71</sup> In 1997, there was a No.3 Document issued by the CC, emphasizing the role of party (World Bank, interview 2002)

<sup>72</sup> World Bank interview, 2002.

<sup>73</sup> The managers, the party secretary, and chief accountant were appointed by it World Bank, interview 2002.

veloping "bond project" that is practically compulsory for commercial banks to finance<sup>74</sup>. In case of larger projects, highest levels of Party and State administration approve their investments<sup>75</sup>. Lately, in early 2003, Economic and Trade Commission (ETC) and LEWC and some sections of the Planning Office merged under the new name of State Owned Asset Management Commission. The merger explicitly concentrated assets to distribute and the nomenclatura of the most important enterprises.<sup>76</sup> All the above suggest that the absolute and relative shrinking and weakening of the net makes the selection stricter but does not change the selection criteria within it.

Similar conclusions may be drawn concerning the debt-to-equity swaps. Debt-to equity construction was introduced in 1999 to provide relief and solutions for 601 selected SOEs, (and to the banks who granted those bad loans many times at government pressure). The debt-equity swaps benefit China's SOEs by reducing their interest payments and allowing them focus on modernizing and restructuring. These enterprises were selected from among the 6,600 loss-making enterprises based on their bargaining capacities<sup>77</sup>.

Prevailing politically rational selection criteria not only involved soft reproduction constraints for the narrowing circle for its members. For the sake of selective allocation, it further enhanced extracting drives within the net, and resource creating efforts outside the net, further strengthening the characteristic pattern dynamics of self-reproduction. Parallel to the tendency of decentralization (burdens and decisions), also revenue centralizing efforts prevail. From 1994 on, repeated revenue centralization actions may be detected through the introduction of newer and newer revenue-sharing techniques. For example: the inclusion of formerly

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<sup>74</sup> World Bank interview, 2002.

<sup>75</sup> In fact, the Planning Commission, the State Economic and Trade Commission still have regular power to be involved in the economic policy decision making in these enterprises. Also, for very large companies like Petro China and Sinopec, economic decisions, business decisions, are usually approved by the State Council and the deputy prime minister or even the party secretary, for very large investments, like 10 billion or 40 billion worth projects (World Bank, interview 2002).

<sup>76</sup> According to the head of the new commission, 64% of the total profits by produced by state sector (160,000 SOEs) were contributed by the 196 SOEs under the new commission's supervision. The strategy of reforming these 196 SOEs is to "encourage those SOEs to be listed in foreign stock market, to diversify the share owners by inviting FDI to buy the shares" (*Li Rongrong*, head of the commission, talked with his counterpart in South Korea, *Workers Daily*, July 8, 2008).

<sup>77</sup> World Bank, interview 2002

exclusively local tax into the rank of shared taxes, the increase of the centralized ratio, the centralization of the subordination of profitable and the decentralization of inefficient enterprises, the inclusion of extra-budgetary funds in controlled official budgets, the decentralization of expenses and the transfer of SOEs' social costs to local budget<sup>78</sup>. All these measures further induce the upward spreading of the shrinkage of the net.

#### THE CONSEQUENCES OF PATTERN DYNAMICS ON THE CHINESE TRANSFORMATION

Let us see what concrete impact did the disintegration, internal restructuring and absolute and relative shrinkage of the net have on its main elements (*Table 1*). The vertical dependency lines within the state sphere of the net became scarcer (merger of supervising organizations) and have shrunk radically. The shrinkage took place by cutting functions, organizations, resources and discretion, and cutting off targets from functions. These developments occurred at higher and lower levels too. The retained tasks and functions of the remaining organizations became decentralized along the levels of the hierarchy and authorities became less interventionist and with decreased power, for lacking distribution potential.

The interlinking threads of the party towards the enterprises and the state bureaucracy due to the same process became also radically scarcer. The remaining party linkages to the state and remaining SOEs and TVEs – even if strongly bound – are attached to a weakening state in its capacity of extraction and distribution within the net and therefore, with less activity through it. This happened partly indirectly, since enterprises were detached from state subordination where interlinking threads reached out, or state organizations were merged, or decentralized or centralized from the given level and administrative functions withdrawn. It happened also directly, since many inter-linking threads to economic units were withdrawn or remained in limbo due to privatization, mergers, centralization, decentralization, close-downs. Those remaining inter-linking threads became weaker and emptied.

Both intra- and cross-hierarchy feedbacks became scarcer and the remaining ones weaker as a result of the weakening of the hierarchical and inter-linking dependency threads, and the declining capacity to distribute resources within the net. The remaining direct inter-linking threads to economy have been differentiated. Some cross-hierarchy (from state-owned

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<sup>78</sup> Csanádi-Lai, 'The Transformation of the Chinese'.

economy to party hierarchy) feedbacks disappeared, their nomenklatura was decentralized, thereby the circle of those fed back was narrowed. The decentralization was selective according to the usual criteria within the net: size and resourcefulness. The larger SOEs were transferred to the LEWCs acquiring distributive functions, smaller ones to Organization Department or to PCs located at ministries. Some transfer of nomenklatura responsibility also occurred, according to the higher level's capacity to siphon away efficient economic units.

In the meantime, new party-state organizations emerged to carry out the changes themselves (leaders group on enterprise reforms and TVE reform): to detach SOEs and TVEs from inter-linking threads through privatization and deciding on privatization. Traditional party organizations (County Party Organization Department) are also engaged in leading self-withdrawal at township and county levels by organizing county and township semi-free elections and free elections at village level.

#### **THE CONSEQUENCES OF THE TRANSFORMATION ON POWER RELATIONSHIPS**

Empirical evidence suggests that changed operating conditions gradually *transform the relationship among the actors*, both among those within the net and with those outside the net<sup>79</sup>. Hardening reproduction constraints and pressures from below spreading upwards and from agriculture to industry gradually softened economic policy and ideology in relationship to market and private capital. At central level economic policy gradually conceded to the pressure of letting go first the small, than middle and presently large SOEs.

Privatized enterprises have restricted contact with state authorities. Party authorities are pressured with less responsibility by workers' grievances in privatized SOEs, and intervention is less frequent and also less possible into share-holding or rented or contracted out enterprises.

Private capital is allowed to enter loss-making enterprises, share in the debt to equity project, to enter the money market, insurance, banking, and lately in buying shares in the largest – most fed back – enterprises under central subordination. Entering the WTO requires the liberalization of regulations, lifting former barriers to FDI inflow, the introduction of the rule of law, etc. Though domestic private enterprises are still suffering from biased credit policy, local authorities are increasingly friendly to-

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<sup>79</sup> Csanádi-Lai, 'The Transformation of the Chinese'.



wards private entrepreneurs and do their best to attract FDI. Local private entrepreneurs play focal role in local social life, authorities try to suck them into the network and offer them crucial positions in economic policy management.

On the one hand, the remaining SOEs began *not to obey* instructions with increasing frequency with the change of the function and the decline of resources of the Planning and Economic Commission. There is also less reason for economic management to comply with the party's instructions. First, the party has less capacity to mediate resource distribution through the resource-less state. Second, enterprises have more chances to attract alternative resources from outside the net and thereby decrease the dependence from party mediation. Third, the capacity to flee and/or empty the net or buy out for individuals increased, decreasing the attraction of party career. All these decrease the interests, willingness and necessity of those embraced by the nomenklatura threads to comply for the sake of individual and organizational interest. The decreased capacity of the members of the party apparatus to intervene in the economic sphere also brings about more willingness to compromise with the economic management. Moreover, since many state assets that became liabilities (subjects for mass demonstration against the party instead of mass mobilization for the party) incite the party to further withdraw.

On the one hand, despite the strong remaining bonds between party and state, empirical evidence shows more conflict, less adaptation, more frequent denial of party's orders or expectations by state authorities. We suppose, that the weakened state as distributor acquires this capacity to resist partly due to the development of alternative legitimacy: that of state leaders as winners of multi-candidate semi-free elections at village, township and in few but growing cases at county level, moreover at different level Peoples' Congress. As a consequence of the development of an alternative field for existential mobility (private sector), Party career is not any more so attractive for state officers either.

The transformation of the net is also changing the relationship between the party-state apparatus and the population. Gradually, and in a scattered manner – where the net was withdrawn, emptied or weakened – spots of civil society are emerging as a consequence of hardening reproduction constraints. For example, the direct elections at village level, semi-free elections on township and county level, where peasants and other citizens become electors in government leadership and party and consequently, the emergence of legitimate leaders. Similar are the formation of horizontal

links (groups) in growing grievances and siege, mass demonstration of fired workers or unemployed in consequence of close-downs. Strikes are held by those workers who are long-lastingly unpaid. In other instances, workers are becoming electors in enterprises from where authorities have withdrawn. Workers are becoming shareholders in enterprises that authorities had privatized. Partly due to the weakening of power within the net, partly to growing social pressure and non-compliance, efforts were made to enforce rule of law. Information channels multiplied and more foreign pressure was encountered for openness, due to the multiplying information channels. Criteria of officials' selection have changed and more and more corruption cases are revealed.

## CONCLUSIONS

The spreading of hardening reproduction constraints within the net, the competitive pressure by the field outside the net and private capital infiltrating the net contribute to the *acceleration* of the characteristic pattern dynamics. They incite increasing efforts and simultaneous difficulties of resource extraction on central level, and with that, to the acceleration of absolute and relative shrinking of the net on national level. This process, in turn, further accelerates the spreading of hardening reproduction constraints within the net on lower levels. Due to this dynamics, while within the net principles of connection of party-state elements remain unchanged, *characteristics* that define the *principles of operation* of the party-state *are vanishing*: dependencies, interest promotion and extraction and distribution of resources *are not any more monopolized*.

Reflecting on the question whether China can *avoid a system-demise* as in Eastern Europe, we have to form the question subtler, separating the *fact* of system demise and the *nature* of this demise. Based on the model and the revealed transformation process on macro level in China, we may stress, that system demise is unavoidable, since both the main elements and the main connecting and operating principles of the party-state structure are gradually, but steadily disappearing. This dynamics is *irreversible and self-reinforcing*<sup>80</sup>, and the room for maneuver is constrained by the struc-

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<sup>80</sup> Andrew Walder arrives to a similar conclusion concerning the irreversibility of this transformation process: "The process of political decline set in motion by departures from central planning is to a considerable degree self-reinforcing. As departures from central planning proceed the costs of reversing them rise and the party's political

ture and dynamics of the net. The net is absolutely shrinking through self-withdrawal, emptying, asset stripping and by cutting off targets of inter-linking threads from the net while the field outside the net is steadily growing. In this respect, reforms placed in the context of power distribution contribute to the systemic self-destruction during self-reproduction. However, the nature of the demise is very different from that of the Eastern European party-states. Due to specific structural reasons, system-demise in China is gradual, partial and localized and upward spreading through absolute shrinking. Economic transformation comes first to political. The disintegration and growing tensions within the net run parallel to outstanding economic growth of the field outside the net. Therefore, economic and social crisis within the disintegrating and shrinking net may be smoothened, though not compensated, by the resources sucked from the field outside the net.

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will, as well as organized capacity to reverse them, declines.” (Walder, Andrew G.: Local Governments as Industrial Firms: An Organizational Analysis of China’s Transitional Economy. *American Journal of Sociology*, vol. 101, No. 2, September 1995; pp. 263–301, at p. 17).