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Bringing the party back in: the CCP and the trajectory of market transition in China

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Abstract

The article suggests a conceptual framework for understanding the logic and dynamics of the Chinese Communist Party's (CCP's) organizational adaptation to market conditions and the consequences of this process for the trajectory and outcomes of the Chinese reform process. I define the CCP's adaptation to market as "entrepreneurial" in nature with party cadres and agencies at different levels becoming not only oriented towards the goal of increasing local economic output and productivity but also directly involved in profit-making activities. I also argue that despite increased opportunities for rent-seeking and corruption, the CCP's struggle for its organizational survival in the process of entrepreneurial adaptation has positively influenced the trajectory of Chinese market transition. By providing its agents powerful incentives to uphold the necessary degree of compliance with central policies, by limiting lucrative "easy avenues" for profit-seeking and value-subtracting behavior, by preventing the formation of powerful interests capable of hijacking the reform process, and by imposing painful but necessary economic rationalization measures, the party became an imperfect but crucial substitute for the lack of institutions necessary to guide the process of creating markets.

Keywords: Chinese Communist Party; Chinese economic reforms

Introduction

One of the major challenges to the scholarly imagination in the era of "the mass extinction of Leninist regimes" (Jowitt, 1992) is the intriguing fact that dynamic

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market-based economic growth in China of the last 25 years has taken place under the continuing political dominance of the Chinese Communist Party (CCP) (Goldstein, 1995; Nathan, 2003). This directly contradicts the well-established idea that the fusion of politics and economics in Leninist–Stalinist systems precludes the development of market forces and that the only lasting remedy for the stagnation of the socialist economy therefore is to dismantle the institutions of communist party rule (Bialer, 1980; Blanchard et al., 1992, 1993).

How did the CCP manage to escape a seemingly inevitable trade-off between its dominant position in the political system and economic progress? What is the party's place in the contemporary Chinese political economy? Answers to these questions are important for understanding the nature of the linkages between Chinese economics and politics and the Chinese developmental path in the reform era; yet the subject of the party's place in the shifting environment of post-reform Chinese society, politics and economics has received only a modest degree of attention in the Western literature.[1]

The goal of the present article is to put forward a conceptual framework that can facilitate our understanding of the logic and dynamics of the CCP's organizational adaptation to market conditions and the consequences of this process for the trajectory and outcomes of the Chinese reform process. I define the CCP's adaptation to market as "entrepreneurial" in nature with party cadres and agencies at different levels becoming not only oriented towards the goal of increasing local economic output and productivity but also directly involved in profit-making activities. I also argue that despite increased opportunities for rent-seeking and corruption, the CCP's struggle for its organizational survival in the process of entrepreneurial adaptation has positively influenced the trajectory of Chinese market transition. By providing its agents with powerful incentives to uphold the necessary degree of compliance with central policies, by limiting lucrative "easy avenues" for profit-seeking and value-subtracting behavior, by preventing the formation of powerful interests capable of hijacking the reform process, and by imposing painful but necessary economic rationalization measures, the party became an imperfect but crucial substitute for the lack of institutions necessary to guide the process of creating markets.

In what follows I critically evaluate existing literature on post-communist transitions, Chinese economic reforms, and the relationship between political power and economic development. I then highlight contours of theoretical framework explaining the relationship between the CCP principals, agents and the trajectory of the Chinese transition to market. Finally, I demonstrate how my argument is consistent with the Chinese reform record.

[1] Notable exceptions to this generalization are Dickson (2001, 2003).

Confronting the CCP's puzzle

China's transition to the market was relatively successful, as measured by most indicators, including increases in GDP, living standards and reductions in poverty (World Bank, 1998, pp. 210–211). To use Walder's metaphor (1995a, p. 963) in contrast to the disappointing (and at times outright disastrous) performance of most of the post-Soviet states, including the key example of Russia, China "has looked more like a sprinting East Asian tiger than a plodding Soviet-style dinosaur mired in the swamps of transition." The net output of the Chinese economy since 1978 has on average increased by nearly 10% per year and the standard of living has greatly improved, as reflected in the World Bank's recent re-classification of the country from "low income" to the "lower middle income" category.

Accounting for the dynamics of the Chinese reforms is a challenging task that has inspired numerous and at times mutually exclusive explanations, provoking a lively debate in the Western academic literature (Woo, 1999; Rawski, 1999). The big piece of the Chinese puzzle is the fact that market reforms occurred under the auspices of the socialist party–state regime. One of the methods for explaining this paradoxical development is to depict the CCP as largely irrelevant to the economic process of the reform period. This point has been most effectively put forward by "market transition theory"—arguably the most rigorous construct in the array of explanations linking market reform and societal change.

According to this theory, pre-reform patterns of authority of the party–state are simply not sustainable under the conditions of market reform. Since the increased scope of market allocation inevitably reduces the scope of bureaucratic redistribution, party–state officials lose their monopoly over resources which leads to a relative decline in their authority and relative gain in economic and social power of producers and entrepreneurs (Nee, 1989, 1991, 1996; Kornai, 1992). Under these conditions, the party becomes increasingly irrelevant to the economy and to the market-engendered socio-economic forces, such as private entrepreneurs.

Not content with the image of an obsolete party–state being ignored and rejected by the new socio-economic forces unleashed by market reforms, other China watchers prefer to rely on the neo-traditionalist paradigm developed in studies of the Soviet polity. According to them, adherents of "market transition" or "civil society" models tend to misinterpret signs of political and economic decay for development.

In writing almost two decades ago about the Soviet communist party, Kenneth Jowitt postulated that when a charismatic organization can no longer identify a compelling transformational task, define it strategically and mobilize significant sections of the organization around both task and strategy, it moves in the direction of a "corrupt" routinization of charisma, resulting in the loss of organizational integrity. With the waning of combat tension vital to a Leninist party's ability to subordinate its members' particular interests to general organizational interests, cadres cease to be deployable party agents and instead turn themselves into patrons protecting their clients in exchange for goods, services and loyalty. The emergent "Leninist neo-traditional variant of political capitalism" combines the party's exclusive qualities and position in society with persistent organizational corruption (Jowitt, 1983).

Lu Xiaobo's research on party–state cadres in contemporary China combines the neo-traditionalist paradigm with the concepts of social and cultural involution. The Chinese party–state, argues Lu, is in the process of "organizational involution," producing neither modern bureaucrats who are rational, role-conscious and rule oriented, nor well-maintained, disciplined and committed revolutionary cadres. Instead, it produces uncommitted, status conscious, and undisciplined *ganbu*. The Leninist party–state, captured by its own agents who distort policies and resist control from above, engages in rent-seeking and predatory behavior (Lu, 2000a,b).

While market transition theory assumes too much change in the Chinese system in the reform era, the neo-traditionalist model assumes too little. Market transition theory is contradicted by numerous field studies which have repeatedly documented that state and party cadres at all levels of the Chinese administrative system are deeply involved in economic decision making, management and profit-making activities taking place in different sectors of the Chinese economy, including the most dynamic and marketized ones, such as rural industrial enterprises (Walder, 1995b). Studies of the Chinese private sector further undermine market transition theory's case. It has been repeatedly observed that instead of a weakening cadres' economic power, the mature development of market transactions and the growth of private entrepreneurship in society have led to a new "interest convergence" and a "symbiotic relationship" between entrepreneurs and party officials (Solinger, 1992; Nevitt, 1996; Wank, 1999a). Market transition theory also seems to be contradicted by one of the most remarkable unintended consequences of China's economic reforms—the proliferation of bureaucratic agencies (Brodsgaard, 2002).

Methodologically, the weakest point of the market transition theory is the assumption that the shift to market allocation per se has inherent consequences for the allocation of economic power. As one of the critics of the theory noted:

> To simply assert that 'redistributive power' is declining and that therefore cadre economic advantage will decline is to evade the central empirical question—whether cadres are able to develop *new* sources of power—not as 'redistributors' but as regulators of markets and private enterprises, brokers and middlemen for market transactions, all through drawing on influence, knowledge, and connections developed in previous years of power (Walder, 1996, p. 1063).

At the same time, the application of the neo-traditionalist model to the reform-era Chinese polity also runs into a number of problems. Most importantly, the preoccupation with structural factors ensuring a unilinear degeneration of the communist polity does an excellent job in explaining systemic corruption and clientelism but precludes any coherent attempt of accounting for their co-existence with the economic growth achieved under the auspices of the Leninist party.

Of ''invisible'', ''grabbing'' and ''helping'' hands

If models specific to the policies of post-communist transition (market-transition theory) and communist regimes (the neo-traditionalist paradigm) do not help in solving the CCP puzzle, the next logical step is to turn to more general theories linking state power and economic development. Here one can identify three dominant approaches: the ''invisible hand'' model, the ''grabbing hand'' model and the ''helping hand'' model.

The neoclassical laissez-faire, ''invisible hand'' model of state and market, does not provide many useful clues to our puzzle. The irony of the situation is that China has succeeded precisely by ignoring the advice widely offered to East European nations by many prominent economic advisors (McMillan and Naughton, 1992; Nolan, 1993; Rawski, 1994). The ''grabbing hand'' model, while sharing the basic logic of the ''invisible hand'' perspective, builds on the insights of public choice theory in its attempt to overcome the ''invisible hand'' rejection of politics and come up with actual strategies for achieving the ultimate goal of preventing political power from ''grabbing '' economic development (Frye and Shleifer, 1997; Shleifer and Vishny, 1998). Yet, the ''grabbing hand'' premise that ''government control is itself the fundamental problem'' resulting in unproductive rent-seeking, precludes the model from accounting for important variations in the nexus between government and economy. The question is: why are certain governments more effective in serving the economy than the others? ''Neo-utilitarian'' reasoning behind the ''grabbing hand'' approach can better account for governmental failures than for successes. To quote Evans (1989, p. 566) ''it is hard to build a positive organizational theory of the state starting with an attitude that the only good bureaucracy is a dead bureaucracy.''

The proponents of the ''developmental state'' in the 1980s and 1990s challenged the neoclassical analysis of the success of the East Asian states by suggesting that Japan, South Korea, and Taiwan ''govern the market'' through a combination of effective long-range polices (such as strategic industrial policies), exacting high performance standards from economic actors, selective sectoral targeting of preferential policies, and focusing on production-driven long-term market expansion (Johnson, 1982; Haggard, 1990; Wade, 1990).

In an influential argument, Evans (1992, 1995) postulated that the foundation of the success of the developmental state is the phenomenon of ''embedded autonomy''—a combination of bureaucracy's corporate coherence (the basis of the state's ''autonomy'') and institutionalized channels for negotiation of goals and policies with economic forces (the foundation of embeddedness). The first part of the formula, corporate coherence, crucially depends on the state bureaucracy's personnel and internal organization such as a rigorous system of recruitment, promotion based on meritocratic principles, a common educational experience, and collectively sanctioned behavioral standards of the organization. The stability and internal career path of the bureaucracy encourage bureaucrats to take a long-term view of the policy implementation and to maximize individual goals via conformity to bureaucratic rules rather than via the exploitation of self-enrichment opportunities presented by the market. Bureaucratic hierarchy, internal discipline, and the applications of sanctions against the pursuit of individual interests at the expense of corporate goals help to ensure the organization's ability to "resist incursions by the invisible hand of individual maximization" (Evans, 1995, p. 58).

The second part of the formula demands Weberian bureaucratic insulation from generalized interest-group pressures to be supplemented by state–society linkages, insuring the exercise of infrastructural (as opposed to despotic) power *through* society by mobilizing economic actors for production-oriented tasks.[2] Under these circumstances, "connectedness" to the surrounding social structure translates into increased organizational competence, intelligence, and channels of implementation, rather than "piecemeal capture" by particularistic exchange relations. An organization blessed by "embedded autonomy" is not involved directly in productive activities, but remains bureaucratically neutral and sees its organizational mission in "promotional" (as opposed to "restrictive") regulation, developing a friendly economic environment, assisting in the emergence of new entrepreneurial groups, supporting the existing ones, and inducing them to undertake more challenging endeavors (Evans, 1995, pp. 13–14; 77–81).

Nevertheless, the "embedded autonomy" concept has its share of problems. The line between the state's "embeddedness" in society and its "capture" by rent-seeking societal groups is thin and not always distinguishable in practice. The literature on economic development is abundant with examples where "clientelist" and "corrupt" polices considered to be the cause of developmental failure in Africa or Latin America. Nevertheless, it has been utilized in the East Asian economies to produce positive results. The shock of the recent Asian economic crisis and the relatively quick recovery of the East Asian tigers from it demonstrate rather convincingly that clientelism and corruption tend to co-exist with successful economic development. This has led some of critics of the "embedded autonomy" perspective to wonder if its analytical concepts have been identified primarily from their effects. (Edin, 2000, pp. 44–45).

The "embedded autonomy" thesis is also poorly suited to the bureaucratic structure of the Chinese case, which until now had made only timid steps in evolving into a modern civil service. The alternative *nomenklatura* system, the foundation of cadre management in the Leninist states, is a well-developed form of institutionalized patronage (Burns, 1987, 1994). Moreover, there is overwhelming evidence that party and state cadres throughout the reform period have both directly participated in profit-making activities and established clientelist ties with preferred businesses and entrepreneurs. While it is tempting to place the Chinese state in the third category of "intermediary" administrative apparatuses capacity of which in fostering and securing positive development change borders on slipping into the various modes of patrimonial predation (Evans, 1989), this would not explain much. The

[2] According to Mann's (1986) influential definition, despotic power refers to the range of actions elite is empowered to undertake without "routine institutionalized negotiation" with society groups. Infrastructural power, on the other hand, is defined as "the capacity of the state actually to penetrate civil society, and to implement logistically political decisions throughout the realm."

crucial question is what preserves this fragile balance, or, more accurately, what enables the developmental part of the equation to overcome the predatory one.

Markets and political power

The idea of an insulated Weberian-type bureaucracy presiding over dynamic economic development has been under heavy criticism from the public choice and neo-institutionalist literature for ignoring the principal-agent problem inherent in any bureaucratic organization. The persistence of problems originating in the asymmetry of information and the possibility of "hidden action" of agents detrimental to the interests of their principal forced public choice literature to concentrate on effective incentive systems to prevent bureaucrats from shirking and effective monitoring devices to punish agents' non-compliance (Moe, 1984). One of the solutions to the problem advocated by the models inspired by the public choice literature is to make bureaucratic administration subject to market incentives to improve government performance, the major incentive being to link the agent's remuneration to output performance (Walsh, 1995).

The idea that successful economic development might originate from political and administrative officials' drive to acquire profits, thus, serves as another explanation for the emergence of the "helping hand" phenomenon, not requiring the presence of the lofty virtues of "embedded autonomy". Building on similar ideas, Mancur Olson proposed a unified model explaining the logic of markets and political power in both dictatorships and democracies.

Olson postulated that if the ruler's "encompassing interest" in the prosperity of his domain is augmented by his capacity to earn an increasing share of his income in the marketplace, the ruler acquires a strong incentive to provide necessary public goods to maximize his domain's income and to keep extraction below the revenue maximizing rate. Thus, the ruling interest exposed to market incentives transcends the dilemma of a "secure stationary bandit" (operating in a market-free environment) torn between an incentive to provide some amount of public goods (as opposed to the unambiguously predatory "roving bandit") on the one hand, and the instinct to maximize the absolute amount of his net extraction from society. The process of the ruler becoming *more* than a stationary bandit leads to positive developmental outcomes (Olson, 1993, 2000).

Changed economic incentives of Chinese officials

Olson's logic fits nicely with the most popular explanations of the dynamism of China's reform period, focusing on the influence of fiscal and administrative decentralization on the incentives of local Chinese officials (Oi, 1999; Walder, 1995b, 1998). Through the 1980s, measures were implemented to reduce the central government's subsidies to local authorities through autonomy—enhancing devices such as "local financial self-accounting." To counterbalance the increased fiscal pressures on local governments, they were allowed to keep the residual from the tax revenues collected from enterprises under their jurisdiction after turning over a contractually specified amount to the next higher level of the government (Wong, 1991, 1992). The fiscal reforms of 1980 also created new sources of extrabudgetary funds for local party–state cadres that were not to be counted as part of the revenue base to which fiscal contracts would apply, and that, therefore, accrued wholly to local jurisdictions. In addition, by directly linking party–state agents' income (in the form of bonus payments) and promotion with industrial performance, the cadre evaluation system implemented by their superiors created a very direct incentive for local cadres to take a personal interest in economic management and "rise or fall " on the basis of economic success (Rozelle, 1994; Whiting, 1999; Oi, 1999).

Saddled with new fiscal and administrative responsibilities and armed with new residual property rights, local governments scrounged for resources and revenues as best as they could. This unleashed a striking annual growth in output and productivity on the part of market-oriented county, township and village enterprises (TVEs). At the same time, key leading cadres and key enterprises and entrepreneurs in the localities became mutually dependent and intertwined. The emergence of a dynamic rural industry had a crucial effect on the overall Chinese reform process by introducing a competitive market environment, affecting other economic players, and helping the Chinese economy to gradually "grow out of plan" (Naughton, 1995).

The logic of entrepreneurial adaptation

Focus on changed economic incentives of local cadres explains not only the dynamism of Chinese rural industrial growth, but also how "the lure of the residual" helped to channel market reforms through the Chinese bureaucracy. Susan Shirk's account of the first decade of Chinese reform expands this explanation by demonstrating how reform measures were made acceptable to lower-level cadres through the process of wide-spread "particularistic contracting" over economic rules, providing Chinese officials with concentrated benefits under new economic conditions while the costs of particularism were widely dispersed (Shirk, 1993).

The explanation of cadre incentives provided by the fiscal incentives model and Shirk's hypothesis of particularistic "playing to" the cadres can serve as a starting point for the analysis of the CCP's adaptation to market conditions. The fact that local CCP committees and cadres at the village, township and county levels played a crucial role in developing and participating in the management of industrial enterprises and businesses represents one type of cadre response to the exigencies of marketization and decentralization. Another form of entrepreneurialism developed at the higher (usually, above township) levels of Chinese administrative system as a response to reduced budgets for bureaucratic institutions. Central authorities' attempts to impose harder budget constraints on bureaucracy generated a widespread phenomenon of party and government agencies and units engaging in business to "produce revenue" (*chuang shou*) for the benefit of the organization and its personnel.

Chuang shou imperative led to the emergence of extrabudgetary ‘‘economic entities’’ allowing cadres to directly participate in entrepreneurial activities and distribute profits as employee benefits among members of their own organizations. Faced with the increased scope of localized regulatory activities due to fiscal reform and decentralization, public agencies, in addition to economic entities, also set up ‘‘self-financing units’’—subsidiary units without budgetary funding—whose operations were financed by the revenue generated from regulation-related activities. Yet another form of entrepreneurialism involved individual cadres quitting their official positions in order to engage in private entrepreneurial activities. Finally, some bureaucratic agencies at different levels of the Chinese administrative system were encouraged to transform themselves into companies or business corporations to cut administrative costs and simplify bureaucracy (Shevchenko, 2002).

The absence of viable societal competitors, such as a commercial middle class, at the outset of marketization in the Leninist systems made Chinese communist cadres the ‘‘gatekeepers’’, controlling entry into market-oriented activities and determining the extent of regulatory and resource constraints to which the economic players are subjected under new conditions. In this sense cadres’ ‘‘redistributive’’ power is not weakened but, on the contrary, is likely to peak throughout the transition period, since cadres are in effect distributing competitive advantages in the new economic environment (Lin, 2001).

Chinese cadres’ and bureaucratic agencies’ various responses to the new economic incentives reflect a general phenomenon of what we may define as the CCP’s *entrepreneurial* adaptation to market reform conditions, resulting in the appearance of cadre-entrepreneurs and agency-entrepreneurs oriented not only towards the goal of increasing local economic output and productivity but also directly involved in profit-making activities.[3] As a result of this pattern of adaptation, leading cadres occupying key positions in party and state administration, and especially the so-called ‘‘first hands’’ (*diyi bashou*)—cadres in charge of business management of the various economic organizations—have been spearheading market development throughout the reform era (Shevchenko, 2002).

A focus on the economic incentives for local officials goes a long way toward explaining the origins of the entrepreneurial phenomenon and the process through which market reforms have been channeled through the Chinese bureaucracy. Yet, the focus on profit-generating opportunities is not sufficient to explain the trajectory of the Chinese reform path. With economic incentives guiding Chinese cadres’ behavior, much of the recent literature made party cadres and agencies, working at the forefront of economic development, look almost indistinguishable from entrepreneurs and firm-level managers. This confusing lack of distinction provokes its critics to argue that the ‘‘fiscal decentralization’’ model in fact cannot prove that

[3] Definition of the ‘‘entrepreneurial’’ form of organizational adaptation is based on the typology of the state agency participation in local economic activities suggested in Baum and Shevchenko (1999). For the early definition of the ‘‘entrepreneurial’’ local state in China see Blecher (1991). See also Duckett (1998) for development/revision of Blecher’s definition.

the outcome of cadres' participation in economic activities is any better than what the competitive market would have produced, if the officials had stayed out of economic affairs in the first place (Steinfeld, 1998, p. 243).

Another and more serious problem is that, not unlike the "helping hand" literature, an explanation of economic incentives cannot account for some of the important features of the Chinese reform process. There is abundant evidence that party cadres' double roles as referees and players in market-oriented activities throughout the process of adaptation, translated into increased opportunities for rent-seeking and acquisition of wealth. China is hardly unique in this respect, since the transition to capitalism as a rule is accompanied by politically influenced transfers (rents) involving the creation of new property rights, and often entirely new economic classes, resulting in the process of initial accumulation of capital. However, the main danger of the process of this "necessary" post-socialist primitive accumulation is the possibility that instead of giving birth to a productive capitalist class it can go "wrong" and descend into "unnecessary" theft and looting (Khan, 2000, p. 38) ultimately producing "capitalists without capitalism" (Eyal et al., 1998). One of the challenges in the Chinese case is to explain a seemingly paradoxical co-existence of dynamic economic growth with wide-spread corruption and rent-seeking.

The idea that the political incentives facing Chinese cadres throughout their transition to the market are not similar to those facing entrepreneurs and should thus be regarded as a crucial part of the story of the Chinese reform, has begun to gain currency in the academic literature. For example, several important recent studies argued that the purely economic explanation of rural industrial growth ignores the important fact that cadre-entrepreneurs' careers crucially depend on the incentives provided by different elements of the hierarchical and bureaucratic structure of the Chinese governance system, such as cadre evaluation systems employed by higher authorities (Gore, 1998; Edin, 2000; Whiting, 1999).

In what follows I build on this emerging emphasis of the interaction of economic and political incentives in the Chinese administrative system to suggest why pervasive corruption and rent-seeking did not undermine Chinese economic development. I also argue that to understand the dynamics of interaction between Chinese politics and economics fully, we have to question many of the assumptions behind dominant conceptual frameworks explaining the process of socialist transition. The next section sketches the alternative approach to economic transition that began to appear in the recent economic literature.

Institutional traps and "clamping down" approach to economic transitions

Both theoretical studies of transitional economies and practical advice given to them by Western governments and international economic institutions in the past 15 years were fundamentally influenced by the view of transition to markets as the process of freeing up entrepreneurial initiative, dismantling institutions of state planning, and acquiring property rights and autonomy from the state. Such "rights-based" perspective is best summarized by privatization–stabilization–liberalization mantra of the neoclassical paradigm. However, accounts focusing solely on market-based incentives for growth are at best incomplete because they fail to address the key question of why economic actors' rights and autonomy are exercised in productive ways in some environments and in unproductive ways in others.

The contours of the alternative approach to market transition started to emerge in the early and mid 1990s when a number of prominent economists argued that the context within which individual maximization takes place is of crucial significance during economic transition. The key to positive developmental outcome is a broader institutional framework of society that provides the incentive structure directing economic and political activity and place restrictions on the choice set of actors so that they would behave in productive way (North, 1990: p. 344, 1997). In his 1993 Nobel Prize speech, Douglas North acknowledged that neoclassical economic theory is "simply an inappropriate tool to analyze and prescribe polices that will induce development. It is concerned with the operation of markets, not with how markets develop" (North, 1994, p. 359). Consequently, getting the property rights "right" is too narrow a conception of what institutional economics is all about. The more urgent need is to get the institutions right, of which property is only one part.[4]

The task of "getting institutions right" is particularly challenging for post-socialist societies. In addition to the almost complete absence of the institutions necessary for the normal functioning of markets, such as instruments for macroeconomic management, legal system and corporate governance mechanism, much of the traditional communist system safeguards against rent-seeking and value-subtracting behavior, however misdirected and inefficient they might have been, are either destroyed or significantly weakened. Such weakness of institutional matrix creates a high degree of probability that, in the process of building markets de novo from the basis of disintegrating command economies, political and economic actors will abuse their new freedoms, autonomy and property rights to engage in value-subtracting and socially unproductive behavior to satisfy their narrow interests. Such unfettered opportunism is socially and economically destructive (Pomer, 2001; Tobin, 2001).

First, in the absence of credible enforcement mechanisms and regulatory safeguards, a new "defective" institutional set-up providing "wrong" opportunities, placing "wrong" constraints, creating "wrong" incentives and rewarding unproductive behavior is likely to emerge. To quote Douglas North again:

> the kinds of skills and knowledge that will pay off will be a function of the incentive structure inherent in the institutional matrix. If the highest rates of return in society are piracy then organizations will invest in knowledge and skills that will make them better pirates (North, 1993, p. 62).

Second, institutional matrix that provides disincentives to productive activity will create organizations and interest groups with a stake in the status quo (North, 1990, p. 90). As persuasively argued by Joel Hellman, delegation of economic

[4] North defines institutions as "humanly devised constraints that shape human interaction."

power and property rights to various economic actors in the course of marketization might produce "short-term winners" who have a vested interest in preserving a partial reform equilibrium that generates concentrated rents for themselves, while imposing dispersed high social costs on the rest of society. Given their greater resources, their smaller number, and their selective incentives for collective action, winners acquire an implicit veto power in the decisions over the future of economic reform, thus protecting their existing rent streams. Hellman concludes:

> The political dilemma of economic reform is not how to sustain reform in the face of opposition from the net losers in the short term, but how to advance reform in the face of efforts by the net winners to preserve the market distortions that produced their gains in the short term. Success of economic reform depends both on creating winners and on constraining them (Hellman, 1998, pp. 222, 234).

Finally, developmentally inefficient institutional choice set can become entrenched through several kinds of stabilizing mechanisms. One of them is coordination effect that increases the costs of deviating from the dominant practices in society. The other is learning effect—economic agents' perfection of skills necessary to make more efficient use of the opportunity structure of a given institutional framework. Yet another one is linkage effect—inefficient norms becoming over time an integral part of a system of other norms, thus further raising institutional transformation costs. This stabilization and subsequent "lock-in" in the socially inferior equilibrium is sometimes referred to as an "institutional trap" (Arthur, 1989; Polterovich, 2001). The process of "primitive" accumulation of capital under conditions of institutional trap is likely to result in tremendous social waste without anything resembling a productive capitalist class ever emerging.

Once having fallen into an institutional trap, the economic system's return to efficient development path is problematic and with time may not make sense any longer. The system undergoes a mutation, developing laws of behavior and evolution of its own (Gaddy and Ickes, 2002). It can absorb external impacts by changing its parameters and returning to the former state of equilibrium once the source of pressure is removed. Moreover, transformation costs associated with bringing the system out of institutional trap are likely to be significantly higher than the initial costs incurred during switching to an inefficient institutional matrix (Polterovich, 2001).

The possibility of the market transition getting caught in the "institutional trap" requires moving beyond simplistic "rights-based" approach to economic transformation towards theoretical concepts better suited for understanding the outcomes of the transition and their causality. The alternative approach to market reform process would focus on the imperative of blocking "easy" avenues for unproductive rent-seeking and predation, imposing clear costs applicable to value-subtracting behavior and precluding the emergence of powerful coalitions of narrow interests capable of hijacking the reform process. To employ the phrase coined in the recent penetrating analysis of the Chinese industrial reform, to understand what incentive structure would lead economic and political actors to behavior compatible with economic growth, it might be useful to view the process of reform not as "loosening up" but as "clamping down" (Steinfeld, 1998, pp. 227–260).[5]

The key is to explain how the incentives producing healthy development outcomes might be imposed during the transition period. On the one hand, the necessity of regulatory safeguards calls for conserving and using the existing organizational capital, such as state institutions, throughout the transition period in order to impose an appropriate incentive structure governing the transition (Murrell, 1992). On the other hand, if the process of market creation in transitional economy is accompanied by Polanyi's "enormous increase in continuous, centrally organized, and controlled interventionism," with state administrators "constantly on watch" (Polanyi, 1944, p. 140) where is the guarantee that these administrators, who are definitely not Weberian legal-rational bureaucrats, will not choose predation over development?

The CCP and the trajectory of the Chinese transition

I argue that the fact that the CCP presided over the course of the Chinese transition to the market economy played a crucial role in neutralizing/reducing some of the grave dangers to market transition identified by the "clamping down" perspective. The logic of the party's struggle for its survival in the process of adaptation to new economic conditions made the CCP a functional substitute for the lack of institutions necessary to guide the process of creating markets. This reinforced the logic of market competition in the Chinese economic system and generated a virtuous economic dynamics resulting in the relative success of the Chinese transition. In what follows, I sketch major roles the party performed in the process of Chinese transition and link it to the transition outcomes.

The role of the party's organizational capital

The CCP succeeded in providing its cadres with material and political incentives to acquire a vested interest in market reform while preserving its organizational structure, discipline, capacity for coercion and monitoring abilities. Despite a widespread perception that Beijing's political, administrative and economic abilities were weakened in the process of reform, the CCP continued to avoid the image of large-scale coordination problems. For example, in the 1980s and 1990s the central authorities were able to tame inflation and curtail localism whenever they seriously committed themselves to the task and demanded cadres' compliance (Huang, 1996; Su and Yang, 2000). While the CCP did not succeed in eradicating corruption and bureaucratic malfeasance, the survival of the relatively strong party–state organization prevented the most disastrous types of corruption, such as outright looting of public resources, from dominating economic activities (Yan, 1999). The fact that the party kept the lines of authority in political and economic realms unambiguous, was of extreme importance, since it also precluded the emergence of powerful

[5] Steinfeld's (1998) analysis focuses on hard-budget constraints for industrial firms.

narrow interests and their coalitions capable of assuming control over the reform process.

It is important to note that cohesion in the Chinese political system was obtained not only through discipline and coercion, but as a result of an incentive-compatible arrangement which converged local officials' interests with the party's preferences (Huang, 1996, pp. 313, 316). Party's unchallenged authority was ensured by the basic fact that party cadres and party and administrative agencies' ability to engage in entrepreneurial activities throughout the transition period hinged on their official position in the party–state hierarchy. The "letting go"/"tightening up" (*fang/shou*) fluctuations of the Chinese reform process (Baum, 1996) together with recurring attempts by the party leadership to get entrepreneurial genie back into the bottle made the option of pure entrepreneurial path to riches far less secure than the status of cadre with potential for entrepreneurial pursuits. The logic of portfolio diversification had a winsome quality to it. This fusion of economic and political power, troubling due to inherent possibilities for official corruption and uneven economic opportunities, also generated incentives for the cadres to display at least some degree of compliance with the norms of organizational and personal behavior that were necessary to retain their posts. The imperative of at least "minimal compliance" in order to realize entrepreneurial opportunities formed a powerful set of constraints on cadres behavior, limiting the most debilitating forms of predatory behavior.

Furthermore, it can be argued that party agents faced a powerful incentive to be recognized as "good" or "model" cadres by their superiors. As Avery Goldstein's persuasive analysis of the structure of the Chinese political system demonstrated, in an ordered hierarchy setting actors not only have a minimum incentive to "get along" with the superiors' policies, but they also get significant political rewards if they satisfy higher levels preferences ahead of others (Goldstein, 1991). According to Maria Edin, the political and economic environment of the reform era, in China, the status of a good cadre was extremely important since it could be translated into a necessary degree of political protection and support from the higher authorities, in case the cadre's entrepreneurial activities made it vulnerable to another round of party rectification or anti-corruption campaign (Edin, 2000).

The meaning of being a model cadre was determined by cadre evaluation system which determined the cadres' income, job security and political status, while satisfying the criteria of the economic development and fulfillment of concrete socio-economic tasks in the cadre's locality or sector of work. Thus, additional opportunities for personal enrichment, even if realized through questionable measures, came as a *consequence* of good economic performance not unlike the fringe benefits for good managerial performance in a corporation (Walder, 1995b) forming further checks on cadres predation on the economy.

Limiting avenues for unproductive activities

Chinese officials' double roles as referees and players in market-oriented activities meant increased opportunities for rent-seeking and outright corruption. Nevertheless, while during the transition avenues for unproductive economic activities were never completely blocked, they were significantly restricted. By preserving its control over major state assets, avoiding large-scale redistribution of state property, conducting gradual privatization focusing on small enterprises and keeping in check spontaneous privatization tendencies, the CCP leaders limited lucrative "easy avenues" for profit-seeking and value-subtracting behavior. Wealth accumulation was encouraged through creation of new enterprises, not through privatization of existing ones. As a result, market competition, rather than the rush to grab property generating windfall profits, became the defining feature of the Chinese transition.

Because of inefficiency of the Chinese State Owned Enterprises (SOEs), Chinese leaders were frequently criticized by Western economists and scholars for their slow and cautious embrace of privatization. Chinese state assumed the burden of subsidizing growing losses of SOEs through fiscal subsidies and increasingly through the so-called policy loans from the state owned banking system. This resulted in the huge amount of debts that SOEs owed to state banks and jeopardized the prospect of creating a modern banking system (Lardy, 1998). Nevertheless, the experience of other transitional economies justified extreme caution in this case. Privatization by itself was unlikely to improve efficiency of large Soviet-style SOEs since, due to their social and political importance, their hard budget constraints were likely to be significantly softened by the state to avoid unemployment and collapse of the social services networks (Gaddy and Ickes, 2002). In the absence of corporate restructuring and improvement of the SOEs performance, privatization would only grant owners, usually enterprise managers, the right to freely redistribute, or simply loot, enterprise assets. In addition, as the Russian case demonstrates, instead of taming political intrusion in markets, privatization provided a powerful instrument by which special interests and individual politicians could perpetuate their power through corruption and patronage. To quote Joseph Stiglitz, the program of transferring assets to the private sector without necessary regulatory safeguards "has only succeeded in putting the "grabbing hand" into the "velvet glove" of privatization" (Stiglitz, 1999). Finally, obsession with privatization may undermine economic actors' interests in creating new enterprises and thus fail to create a framework of competition in the economy. For example, privatization of industries capable to provide instant wealth with minimum managerial effort, such as resource-exporting industries and the wholesale trading forms that export raw materials, would cause economic actors to ignore less profitable manufacturing sectors.

Maintaining capital controls was another important measure limiting value-subtracting behavior during the transition. While Chinese leaders announced current account convertibility of its currency at the end of 1996, they did not move to capital account convertibility, and thus limited the incentives and scope for asset stripping and siphoning the wealth out of the country (Qian, 1999).

Short-term winners and competition

As Chinese party–state cadres and agencies used the uneven pace of economic liberalization and resulting market distortions to seek profits, much of their economic activity inevitably focused on the creation of rents. Rent-seeking has been widely documented in the studies of the reform era and its negative effect on Chinese economic performance became, together with corruption, one of the main arguments against Chinese path of reform. The question which is rarely asked is why such pervasive rent-seeking did not undermine the prospects for Chinese economic growth.

It seems that shifting attention from the conventional focus on the input costs of rent-seeking, to the outcomes of rent-seeking can be a step towards explaining this puzzle. As a recent study of rent-seeking in East Asian economies argues, these outcomes can be value-enhancing, because:

> while rents are always excess incomes in terms what the recipients would have accepted given their next best alternative, they are not always excess payments in terms what is *necessary* to pay them to produce the good, provide the service or carry out the activity in question (Khan, 2000, p. 22).

For example, in Asia rent-seeking was widespread during the high growth period.

The dynamics of the Chinese cadres' adaptation to the market conditions clearly points to several initial reasons why even seemingly "unproductive" rent-seeking on behalf of cadres and agencies was conducive to the success of the marketization process. First, the provision of the opportunities for cadres and agencies to derive concentrated benefits from rent-seeking, clientelism and sometimes outright corruption was a price for Deng Xiaoping's "within system" reform mongering since it neutralized bureaucratic opposition to the market. To use my favorite Samuel Huntington's quote, "in terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized, honest bureaucracy" (Huntington, 1968, p. 69).

Second, cadres' and agencies' private interests under new economic conditions were vital to the process of a continuous and relatively rapid diversion of scarce resources from plan to market and thus to the expansion of market reforms and increased level of competition in the economy (Francis, 1999). Finally, ties between entrepreneurs and their companies and public agencies/officials, even while resulting in the creation of rents, stimulated commercial activity, which, otherwise, would not have occurred and created stable expectations for both sides ultimately conducive to marketization (Wank, 1999b).

Hellman's model identifying perverse incentives of "short-term winners" of the initial stages of marketization was undoubtedly relevant in the process of China's gradual economic liberalization. However, due to the CCP's strong organizational presence in the system, benefactors of partial reforms were numerous, small-scale and economically weak. They ultimately could not hijack the reform decision-making process and impose their will on the reformers. This dramatically influenced the dynamics of unproductive rent-seeking making it less harmful for the economic development. As argued by Yi-Min Lin and Yingyi Qian, since the entry to unproductive rent-collection at each stage of marketization was relatively open, initial unproductive "monopoly profits" tended to be rather quickly eliminated by competition (Lin, 2001; Qian, 1999). For example, state control over the prices of inputs and products, and the unevenness of the degree of relaxation of such controls generated considerable opportunities for cadres to profit from price discrepancies. But profits from arbitrage tended to wither away as more and more cadres were seeking arbitrage-based rents, the fact reflected in the quickly changing focus of arbitrage activities. (Wu, 1996; Gong, 1997).

Similar logic drove economic actors' competition for special regulatory treatment from higher authorities—the major dynamic guiding expansion of market forces throughout the Chinese transition. Economic enterprises of various kinds actively sought ad hoc favors (in the form of getting access to scarce state-controlled resources, entrepreneurial opportunities and exemptions from official policies) from cadres and agencies to obtain a competitive edge under the conditions of market (Lin, 2001). Replicating the same pattern on a grander scale, local cadres lobbied higher authorities for particularistic benefits such as the right to be the "early" liberalizers to get a competitive edge over their neighbors. This produced a rush to offer preferential economic policies such as establishing "special" investment zones, "coastal open cities", "economic and technological development zones" and various economic programs throughout the country in the 1990s (Yang, 1996). But as with the entry into rent-collection, this favor-seeking was also relatively unconstrained. As more enterprises and localities were getting the special deals, the gains associated with "one step ahead" status tended to diminish. Market and avenues for economic growth were expanding but so did the competition between the favor-seekers.

Thus, the structure of incentives imposed by the party on its agents set the limits for rent and favor-seeking and created incentives for economic actors to go beyond these practices, that is switching to profit-seeking and innovative economic activities. For example, it has been observed that in the 1990s some of the "usual suspects" of rent and favor seeking—cash-strapped state agencies and their individual bureaus—engaged in productive, profit-seeking, and risk-taking entrepreneurial activities (Duckett, 1998).

Some of the studies questioned the quality of the Chinese economic performance achieved under the auspices of party cadres. The argument was that the cadres' search for windfall profits based on first mover's advantage in filling the "niches" not covered by the planned economy, led to expansive but inefficient growth relying on administrative guidance of enterprises. This led to a number of economic problems, including sub-optimal size of investment projects (a result of particularistic bargaining over economic resources instead of striving for more efficient "economy of scale" solutions) and lack of regional specialization and division of labor. Expansionary economic strategy resulted in oversupply of the same products and led to dramatic underutilization of production capacities (Gore, 1998, 1999).

But, again due to the absence of powerful coalitions of special interests which could have preserved initial windfall profits by limiting subsequent entry, Chinese non-state sector development was free and unconstrained resulting in massive competition. Proliferation of TVEs (township and village enterprises) resulted in stiff product market competition which together with price liberalization eliminated the cushion of high initial profits and drove thousands of enterprises out of business. In 1996–2001 around 80% of the TVEs had undergone internal restructuring. In fact, the profits of all Chinese firms tended to shrink under the influence of competition for product and factor markets (Naughton, 1995).

Increased competition was a decisive factor in the behavior of entrepreneurial cadres at the low levels of the Chinese governmental hierarchy. Small industrial bases, clearer financial incentives, harder budget constraints, fewer non-financial interests in enterprises and greater capacity to monitor them made the cadres less able and less willing to tolerate poor financial performance of local enterprises and businesses (Walder, 1995b). Over time, fundamental forces of entry, competition and economic growth have caused major readjustments in the economic strategies of local party–state agencies. As demonstrated by the recent field studies, by the mid-1990s increasing competition, falling profits and expansion of the local economy beyond local cadres monitoring capacity forced the leadership to divest themselves of unprofitable enterprises by leasing or selling them. Since 1997, privately owned TVEs have accounted for over half of all TVE value added. Thus privatization is taking place at the lower levels of Chinese system, but it occurs as a logical part of emerging framework of competition in the economy. Similar economic processes forced the governments of more private sector dominated localities to develop new forms of shareholding to mobilize investments beyond the capacity or relatively small-scale local firms (Walder and Oi, 1999; Oi, 1998).

Economic and political rationalization

Throughout the transition period reformist elements in the party leadership, concerned about challenges to the party's organizational coherence, engaged in "learning by doing" and by trial and error attempted to mold organizational structures capable of sustaining healthier economic development, exerting pressure on the stakeholders in the politics of partial reform, and gradually expanding the scope of market regulation.

Instead of getting bogged down in the quagmire of narrow interests, China since early 1990s has demonstrated a persistent tendency towards economic rationalization aimed at the creation of general rules that govern the entire economy, permit competition across a broad range of activities on a level playing field and harden budget constraints for most of the economic actors (Yang, 1999, 2001; Qian, 2000).

In their attempts to impose new rules on economic players, undermine the positions of vested economic interests of partial market reforms benefactors and to force them to switch to more efficient economic practices, Chinese leadership also made a strategic use of the convergence process with international economic and legal norms. In 1998–2001, China dramatically accelerated efforts to join the World

Trade Organization (WTO) despite the fact that since 1995 admission was subject to increasingly stringent standards. While 1994–1997 saw escalation of disputes over the terms of Chinese accession, by spring of 1998 Chinese leaders revised their traditional position that China as a developing country should be offered a generous timetable of complying with WTO rules. They also managed to overcome fears of the entry negative repercussions to a number of important sectors of Chinese economy. One of the main reasons behind the WTO entry was that membership was perceived by Zhu Rongji, Premier of the State Council, and his command as reform by proxy, an additional tool to implement economic rationalization measures, reorientation of the state functions and increasing competition in the economy (Fewsmith, 2001). Committing and then appealing to "impartial" international norms to further concrete political and economic goals is an appealing strategy that minimizes the extent of elite conflict over "painful" policies while providing extra leverage for reformers.

Despite abandoning attempts at radical political restructuring in the late 1980s, the CCP leadership decided to implement cautious program of political rationalization, focusing on promotion of democratic grassroots elections at the village level, upgrading the role of people's congresses, strengthening the legal system and gradually introducing competitive and open selection of civil servants. These incremental political reforms aimed at diffusing challenges to the CCP's authority and improving the quality of Chinese governance. The key goal of the political rationalization project was to better manage societal backlash from reform-induced dislocations by directing popular resentment onto locally accountable state agents (Oksenberg, 1998) and to create meaningful feedback mechanisms capable of alerting the party to problems in its relations with the populace.

By empowering citizens at the lower levels of administrative system, by creating or resuscitating institutions more accountable to societal forces and by reforming its cadre system to be more in touch with social demands, the party creates additional safeguards against value-subtracting behavior. In addition, by bridging disjuncture between the state and society, the power of the party is reconfigured, moving from a "despotic" form, poorly suited for market-based dynamism to a more sophisticated and market-friendly "infrastructural" form. In the process, the CCP acquires opportunities to reinvigorate, modernize and rationalize itself, improve its information gathering, policy planning, and its policy implementation modes (Shue, 1994, p.83). By upgrading the political status of private entrepreneurs and by their inclusion in its ranks (Dickson, 2003), the party increases its chances to reinvent itself, to remain relevant to the Chinese political scene and to succeed in further adaptation of its mission and identity.

Conclusion

To sum up the article's argument, political and economic incentives imposed by the CCP on its agents and agencies generated a dynamic virtuous circle nourishing fundamental forces of entry, competition and economic growth and reinforcing the logic of the market with the logic of the party's struggle for organizational survival. As a result—and notwithstanding the increase in the incidence of corruption—a significant portion of the Chinese elite's reform-era entrepreneurialism has been productive and socially efficient.

The Chinese case reminds us about the crucial importance of the structure of incentives guiding the behavior of economic actors in the transitional economy. The incentive structures necessary to generate anything even remotely resembling economically and socially efficient outcomes do not emerge automatically as a consequence of individual rationality or profit-maximization. In fact, in the case of transitional economies, individual rationality is often logically inconsistent with socially rational behavior. A transitional economy is not a super-Coaseian world with a self-enforcing efficient equilibrium eliminating socially wasteful predation. Transitional societies often waste their chances to become rich through rapid catch-up growth because they fail to develop efficient institutions and design sound economic policies. To use Mancur Olson's vivid metaphor, huge bills are much too often left on sidewalks instead of being picked up (Olson, 1996).

The example of the Chinese transition, and the CCP's role in it, proves that these "efficient" institutions need not be perfect. The relative success of Chinese reform can be best understood from a positive rather than normative perspective (Qian, 1999). All post-socialist economies have considerable potential for improvement if only because of huge allocative distortions and distorted incentives of the socialist planning system. Even highly imperfect "second-best" institutions can dramatically improve outcomes if they perform (by default or by design) several crucial functions, such as limiting opportunities for value-subtracting behavior and preventing the formation of powerful narrow interests.

The paper's argument may also be placed in the context of some of the important debates in the literature on Chinese reforms. In search of a clue to Chinese reform dynamism, two economic schools of thought remained dominant throughout much of the 1990s. One attributed China's good economic performance to the factors regarded as crucial by the "transition orthodoxy," that is, by increasing liberalization, internationalization, and privatization of economic activities (Sachs and Woo, 1994; Woo, 1999; Ma, 2000). Correspondingly, it viewed the innovative institutions engendered by "Chinese gradualism" as "simply imperfect substitutes for normal market institutions that would have provided China with at least as rapid growth" (Woo, 1999, p. 119). The other saw the key to Chinese success in its gradual and successful economic experimentation which fostered the emergence of the new economic forces that have promoted growth while avoiding "big bang" economic liberalization and preserving overall economic stability (Naughton, 1995; Rawski, 1999).

It is probably true that in economic terms the heated debate about "big bang" versus "gradualism" is no longer useful since "even the most ardent enthusiasts of rapid transition now recognize that the road from plan to market must be long and tortuous" (Rawski, 1999, p. 153). Yet, it seems that the "clamping down" approach to the Chinese transition adds a new dimension to the discussion by drawing attention to the interface between the economics and politics of transitions to market. The CCP-presided gradualist approach to economic transformation, Popper's "piecemeal social engineering," not only made sense economically, but was also a wide political choice conducive to continuing progress in the direction of a properly functioning market economy and the emergence of developmentally minded officials and entrepreneurs at different levels of the system.

The party's record of creating foundations of a market economy in China is impressive, but so are the challenges to the Chinese economy and politics lying ahead. Finding a solution to the problem of thousands of inefficient state-owned enterprises, managing the rise in urban unemployment, ameliorating rising rural versus urban and coastal versus interior inequities in income distribution, implementing the badly needed reforms in the country's troubled banking system, revamping social welfare system and keeping in check the official corruption will require a lot of tough and frequently painful actions. To carry out these policies while avoiding a sudden drop in economic performance and by paying constant attention to the most focal points of societal stress is the daunting task of the fourth generation of party leaders who officially assumed power at the 16 November 2002 Party Congress. But an even greater challenge is to continue the process of the party's adaptation to the changed environment. With the creation of market institutions and the completion of the post-socialist transition, the party came close to fulfilling its somewhat ironic reform-era task of "saving the nation through business." To survive the next stage of its adaptation and to "progress with the times," the party will have to develop a new role for itself in the Chinese political system and possibly in the process significantly modernize the system itself.

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