

Regulation and Regulatory Politics in China's Tiered Economy

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This paper attempts to use a particular politico-economic phenomenon in China, the emergence of regulatory authorities along the lines of a "regulatory state," as a prism through which to examine the overall nature of China's political economy. To do so I start by examining the reasons, from a theoretical viewpoint, why we might expect a regulatory state to be emerging in China. I also examine comparative cases – primarily from Euro-American tradition and the East Asian developmental tradition – that help bring into relief some of the major features of China's system of economic governance. The main points of these sections are: (a) it makes a lot of sense to study China's emerging system of economic governance in China as a window to understanding the nature of the political economy as a whole; and (b) a mixture of the developmental state model and European experience are the most useful comparative markers.

At a more meta-level of analysis, this paper attempts to address a question central to the conceptualization of this conference: does China have a capitalist economy and, if so, what kind of capitalist economy is it? To get at this question, the paper introduces a descriptive and

heuristic device for thinking about China's political economy that, while quite commonsensical, is overlooked in much of the literature. That device is the notion of a "tiered" economy and, extending from that, a "tiered" system of economic governance. I conclude with a brief reflection on the nature of capitalism in China.

Why Consider the Subject of Regulation and the Regulatory State?

One of the major trends in global political economy of the early twentieth century was the establishment of centrally planned systems governing socialist ownership. What of capitalist market economies? Far from being the obverse of the socialist planned system, the major trend of the twentieth century, for capitalist economies, was to develop regulatory systems in which the state had the task of fostering successful markets.¹ When the Chinese reform leaders embarked on the path to a market driven system, and declared the twilight of the era of ministry-led economic governance typical of the distributive state, it was clear that some form of "regulation" would have to come into being. For regulation and a "regulatory state" are to serve the function of economic governance in a way that ministries, wholesale public/collective ownership, and state provision of services had done previously. In order to understand Chinese political economy, then, it is only natural to think about the notion of a "regulatory state" in China.

¹ On these relationships, see the classic works of Charles E. Lindblom, *Politics and Markets* (New York: Basic Books, 1977) and Neil Fligstein, "Markets as Politics: A Political-Cultural Approach to Market Institutions," *American Sociological Review* 6 (August 1996).

What do we mean by “regulation”?² A range of meanings, generally varying according to the scope of activity considered, has been applied. These have been summarized by Jordana and Levi-Faur³ as ranging between (1) a set of authoritative rules, often accompanied by some administrative agency to monitor and enforce compliance; (2) the aggregate efforts by state agencies to steer the economy; and (3) most broadly, all mechanisms of social control. I discard the third definition as too broad for the domestic systems of economic governance under consideration here (though Jordana and Levi-Faur [5] find it in increasing use among constructivists in International Relations). As between the first and second definitions, the first indicates a more minimalist state role, particularly in terms of ownership. Following Steven Vogel’s work on “freer markets, more rules,” however, this “minimalist” view does not mean there are not extensive rules and a huge rule-making apparatus.⁴ The second definition implies a more activist state – a state that is more directive of the market. It also holds the possibility of public ownership. Much of the literature on regulation of market economies has assumed that the first definition is appropriate, and in particular is normatively desirable. In Europe, particularly before 1990s, the second definition was commonly used.

As a second definitional point, it must be noted that a distinction is commonly drawn between “economic regulation” and “social regulation.”⁵ Economic regulation is directed

² There is an enormous literature on regulation of market economies within the disciplines of economics. One of the many useful summaries (this one for the UK context) is C.D. Foster, *Privatization, Public Ownership, and the Regulation of Natural Monopoly* (Oxford: Blackwell Publishers, 1992). While the various strands of that literature shed significant light on aspects of the problem of attaining efficient and/or just regulation, they are less useful – it seems to me – for understanding the political choices and structural constraints faced by the Chinese leadership in establishing its regulatory system.

³ Jacint Jordana and David Levi-Faur, “The Politics of Regulation in the Age of Governance,” in Jacint and Levi-Faur (eds.), *The Politics of Regulation* (Cheltenham UK: Edward Elgar, 2004), pp. 2-5.

⁴ Steven K. Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Ithaca: Cornell University Press, 1996).

⁵ A third category of regulation is not considered in this paper: self-regulation. Self-regulation implies the state depends on societal actors, primarily in the professions, to police themselves – a tactic that can be beneficial to clients, but also can be used to create monopoly status for a single “professional association.” On the prospects for

primarily at reducing monopoly and/or the costs associated with it (in the case of natural monopolies). Social regulation is aimed at protecting consumer from market failure, such as environmental degradation and consumer fraud (fraudulent products such as pharmaceuticals). It also is aimed at protecting workers – occupational safety.

This hand wringing over the choice of definition is not a mere intellectual flight of fancy (not completely anyway). For, *normatively*, it is the elements of political economy that are corollaries of the first “minimalist” view that has been ascendant as part of the “regulatory wave” of the 1990s. Significantly, this is the time period in which China’s leaders have been thinking about economic governance of markets. The second, while still in plenty of evidence in actually-existing economies, has seen its star decline as a normative model. An implication is that there is ample opportunity for a gap between the aspirational or symbolic public side a la the minimalist view, and the reality of the more interventionist side.

More particularly, the vision of the regulatory state that has been swept in over the last twenty years is modeled clearly on an idealized version of the American system. Institutionally, the hallmark is the independent regulator. This means the regulators maintain substantial autonomy from political organs – “political independence” – as well as being separate from and impartial to the firms they regulate.⁶ Normatively, the job of the independent regulator is to create a level playing field between market actors without regard to the makeup of the market actors. The oft-used analogy of “referees” in a sports game draws a contrast with government as a “player” in the market, or as a “promoter” of industry. In situations of market failure, the main

self-regulation of the business profession, see Margaret M. Pearson, “Business Professionalism in Mainland China: Wading in Shallow Waters,” paper presented at Conference on Professionalism in China, Harvard Law School, Cambridge Mass., January 30, 2005.

⁶ Political goals must be reflected in regulators’ actions; independence is to be from ad hoc interference by political bodies that lack clear authority.

goal of the regulator becomes anti-trust. This has led to a further elaboration of this model: regulator as pro-competition. In contrast to the traditional notion that regulation constrained the competitive nature of markets, there is now common acceptance that, if rules are transparent and applied evenly, and with certain pro-competitive policies carried out by regulatory authorities, competition is enhanced by regulation. The tool deemed best to promote this end, and applied to some degree in the European context, is “competition policy” (a new version of industrial policy) in specific sectors and/or overarching competition authority.⁷ But promoting competition begs the question: competition compared to what? Indeed, competition policy can promote mercantilism in a context where the desire is to enhance competition through the break up of monopolies, but to strengthen the newly structured oligarchies to be competitive with international firms. The idea that regulation is consistent with the promotion of competition is highly relevant in China’s strategic industries, as we shall see, since a main goal of regulators is to structure competition.

Regulation is also envisioned to be consistent with another equally expansive term, “rule of law.” The rules of pro-competitive regulators are, in the ideal, transparent and based on expertise, and subject to administrative redress.⁸

Whether independent regulators of the regulatory state actually behave in the way characterized – as agencies capable of making expertly correct decisions in a centralized way and independent from government and business – is, unsurprisingly and with merit, debated.⁹

⁷ Jordana and Levi-Faur, p. 6. This work distinguishes “regulation-of-competition,” referring to an overall competition authority, and “regulation-for-competition,” referring to sector specific policies.

⁸ Martin Lodge, “Accountability and Transparency in Regulation: Critiques, Doctrines and Instruments,” in Jordana and Levi-Faur (2004), pp. 124-144.

⁹ Scott, for example, has argued that modern independent regulators are characterized by fragmentation and inefficiency. Colin Scott, “Analysing Regulatory Spaces: Fragmented Resources and Institutional Design,” *Public Law* 2001, pp. 329-353. The famous critique of “independence from business” with the alternative theory of

Whether reality lives up to the ideal, though, it is not too strong to say it is hegemonic in the early twenty-first century. Indeed, the weight given internationally to the pro-competitive independent regulator, underlain by the normative idea that the regulatory state (however defined) is the *modern* system of economic governance, is truly astounding. By this I mean there is no alternative model to the independent regulator presented. This hegemony is perpetuated by all major international organizations working, including the World Bank and International Monetary Fund, World Trade Organization, Organization for Economic Co-operation and Development (OECD), Asian Development Bank, etc. It is a core part of the advice offered countries as diverse as Korea (South), Mauritania, Serbia, and Vietnam by private consultancies in international economic development.¹⁰

Measured in terms of the establishment of regulatory institutions, moreover, it is clear that a wave of the establishment of independent regulators started in the 1990s and continues to this day. An undeniable process of international diffusion – some of it merely symbolic, and some of it representing genuine learning – has occurred.¹¹ Part of the drive behind diffusion is coercive and/or negotiated. Part of it is for effective enmeshment with the global regulatory order and global norms. Part of it is to genuinely fulfill the function intended for independent regulators. Part of it is to stake a claim to have a legitimate system of international governance (symbolic).

Regardless of specific reasons, the model has spread. Following the American example first established in the 1930s but, more importantly, influenced by the various international and

“regulatory capture” is George Stigler, “The Theory of Economic Regulation.” *Bell Journal of Economics and Management Science* 6 (2; 1971), pp. 3-21.

¹⁰ See, for example, the newsletter *The Better Regulator*, the work of the private consultancy Jacobs and Associates, online at <http://www.regulatoryreform.com/newsletter/Jun-2005-06-09-05-E.pdf> (accessed April 26, 2006).

regional advocates, numerous European countries have established independent regulators in multiple sectors.¹² The Chinese government has been made much aware of this model, in large part through its contacts with international organizations such as the World Bank, the OECD, the Asian Development Bank, and the World Trade Organization.¹³

In form, many of China's reforms are consistent with, and informed by, key tenets of the global wave of regulatory reform¹⁴: releasing some economic functions from direct government management; establishing regulators as market "referees"; and increasing the capacity and efficiency of the economic bureaucracy. As the diversity of reasons for following this regulatory wave implies, however, there has yet to be convergence. Rather, we have institutional isomorphism . . . a case of the same form with very different ancestry.¹⁵ Domestic context – particularly domestic politics, institutions, and norms – strongly molds the manner in which regulatory reinvention is realized in practice. Thus, while there may be discursive convergence between the global wave of administrative restructuring and a government's stated goals, convergence in practice is often limited.¹⁶

It is not especially useful merely to point out that this disconnect between discourse and practice holds for the case of China. What is more useful is to attempt to explain the manner and

¹¹ David Levi-Faur, "The Global Diffusion of Regulatory Capitalism," *The Annals of the Academy of Political and Social Science*, Vol. 598 (2005), pp. 6-9.

¹² Fabrizio Gilardi, "Spurious and Symbolic Diffusion of Independent Regulatory Agencies in Western Europe," paper presented at the workshop "The Internationalization of Regulatory Reforms," Center for the Study of Law and Society, University of California, Berkeley, April 25-28, 2003.

¹³ Organisation for Economic Co-operation and Development (OECD), *China in the World Economy: The Domestic Policy Challenges* Geneva: OECD, 2002); World Bank, *Building Institutions for Markets: World Development Report 2002* (New York: Oxford University Press, 2002).

¹⁴ Elaine Ciulla Kamarck, "Globalization and Public Administration Reform," in Joseph S. Nye and John D. Donahue (eds.), *Governance in a Globalizing World* (Washington, D.C.: Brookings Press, 2002), pp. 229-252.

¹⁵ The idea of institutional isomorphism is suggested in Fabrizio Gilardi, "Institutional Change in Regulatory Policies: Regulation Through Independent Agencies and the Three New Institutionalisms," in Jordana and Levi-Faur (2004), pp. 75-77.

sources of this divergence. This is most easily addressed by establishing a comparative framework, which is done in the following section.

Comparative Markers: The Developmental State and the European Experience

This conference has been organized around consideration of three dominant frameworks for understanding contemporary Chinese political economy: the developmental state model (with relevant comparisons being primarily East Asian industrializing nations; transition from plan to market (Russia and Eastern Europe)¹⁷; and crony capitalism. In my current understanding, the latter two frameworks do not yet provide much insight into the emerging system for governing the Chinese economy. It is conceivable how a combination of the two might be useful for explaining the nature of oligarchy in China's "commanding heights" industries (oil, energy, telecommunications, etc.). Indeed, the break up of Chinese monopolies into oligarchic structures, as we shall see, undoubtedly is characterized by personalistic ties between state and management as reminiscent of Russia's "oligarchs" and of crony capitalism as practiced in, e.g., the Philippines. The corruption involved in the transference, at the local level, of collective assets to private ownership and/or management, and nascent efforts to regulate this behavior, also might lend itself to analysis through the prism of crony capitalism. Unfortunately, my current research does not at this point equip me to make these connections to China's regulatory state.

¹⁶ Joel D. Aberbach and Tom Christensen, "Translating Theoretical Ideas Into Modern State Reform: Economics-Inspired Reforms and Competing Models of Governance," *Administration & Society* Vol. 35, No. 5 (2003), pp. 491-509.

¹⁷ The transition model focuses inadequately on governmental institution building (re-regulation) to govern the economy through and past the transition. Moreover, the model is less useful for China because it assumes that privatization is thorough, whereas in China privatization has been intentionally partial.

The developmental state model does usefully capture some of the ways that China's state is attempting to regulate the economy; in particular, the Japanese experience is a useful point of reference. It is useful because it places the state at the center of the action, and sees an expansive and ongoing role for the state. Indeed, the developmental state model tolerates substantial government intervention to structure markets, often in favor of particular firms whose failure would impose unacceptable social costs. Hence, the state has preferences as to the specific market actors, and favors in particular those firms that stand to enhance the international competitiveness of national firms. The model encourages market stability. It discourages "excess competition" that might reduce profits of favored firms. These policies typically are to be carried out, with great autonomy from political or civil forces, through comprehensive industrial policies, usually attached to comprehensive or sector-specific bureaucracies – Japan's MITI being the archetype.¹⁸

Regulatory reforms in Japan in the 1980s brought a modicum of improvement in market competition in strategically-designated sectors, and some privatization. It is widely concluded, however, that they did not significantly reduce the government's control over business, or drastically move Japan toward the ideal regulatory state. A new wave of regulatory reform has taken place in Japan in the wake of the 1997 Asian Financial Crisis. Despite ongoing changes, however, bureaucratic rigidity and continued anti-competitive practices have prevented sufficient reform to foster recovery from deep economic recession.¹⁹ Put more positively, T.J. Pempel's

¹⁸ On Japan's developmental state, see: Organisation for Economic Cooperation and Development (hereafter OECD), *China in the World Economy: Domestic Policy Challenges* (Paris: OECD, 2002), 365-6; and T.J. Pempel, "Regime Shift: Japanese Politics in a Changing World Economy," *Journal of Japanese Studies* 23, no. 2 (1997).

¹⁹ Sumner La Croix and James Mak, "Regulatory Reform in Japan: The Road Ahead," in Magnus Blomström, Byron Gangnes, and Sumner La Croix, eds., *Japan's New Economy: Continuity and Change in the Twenty-First Century* (Oxford: Oxford University Press, 2001).

claim that substantial foundations laid by Japan's developmental state cannot be easily dismissed, despite strong pressure on the country to reform, rings true for China as well.²⁰

Despite the usefulness of the developmental state model, it is inadequate as a single prism through which to analyze China's regulatory state. It is inadequate for two main (and quite different) reasons. First, the developmental state model does not capture the element of international diffusion of a hegemonic model (despite the absence of convergence in reality), as discussed above. Second, the developmental state model does not adequately account for the diversity of types of control of the economy – the idea of “tiers” to be discussed below.

So what other comparative markers can be used to better frame and understanding of China's regulatory state? We are in the perhaps surprising position of needing to draw on the Anglo-European model, and especially the European experience. The spread of the independent regulator model has been much deeper in Europe than in Asia; like China, and unlike Japan and Korea, Europeans have embraced the model of independent regulators – in form if not (also as in China) wholly in content. As Majone commented in 1996, “Statutory regulation by independent agencies – sometimes called, for historical reasons, ‘American-style regulation’ – is rapidly becoming the most important mode of regulation, indeed the leading edge of public policy-making in Europe.²¹ Considered to have had a late arrival in Europe, the continental governments adopted versions of the independent regulator model in a similar time frame as in China: the 1980s and 1990s. The UK and France in fact had adopted the model in the context of the wave of social regulation (for environmental, consumer, and worker protection) in the

²⁰ T.J. Pempel, “Revisiting the Japanese Economic Model,” in Saadia M. Pekkanen and Kellee S. Tsai (eds.), *Japan and China in the World Political Economy* (New York: Routledge Press, 2005), pp. 29-44. The China-Japan comparison is made in Margaret M. Pearson “The Business of Governing Business in China: Institutions and Norms of the Emerging Regulatory State,” *World Politics*, Vol. 57, No. 2 (January 2005), pp. 296-322.

1970s.²² As privatization movements swept these countries and others in the 1980s and 1990s, independent regulators were established for economic regulation. The need to provide competition of privatized firms, so that private monopolies did not simply replace public ones, led Europeans to turn to the natural source for a resolution, the United States. As in the case of China, the Europeans in recent decades have been strongly influenced not only by the extant American model but also by international agencies, notably the OECD.²³

The European experience with regulation is also useful for understanding China – more useful than the American experience – because of the normative acceptance in Europe of mixed economies and state intervention. (Normatively, the contrast is with the U.S., but not with East Asian developmental states.) Europeans, despite trends toward privatization, have started from a position that state intervention, whether ownership or relatively deep control, is acceptable, in contrast to the deep American ambivalence and even hostility toward state intervention. (Refer again to the discussion of “minimalism” above.) Europeans have deemed it quite natural to continue to have partial state ownership of industry at the same time as regulating it, using the mechanism of separating regulation from management. This is the case, for example, in the French and German telecommunications sectors, which retain significant state ownership. Procedurally, the establishment of independent regulators (for economic regulation) in Europe has gone hand in hand with at least partial privatization, or a reduction of the state’s role, much the same as in China – and in contrast, again, to the American process whereby regulation meant an *increase* in state control. From the start, moreover, “the commitment to competition policy

²¹ Giandomenico Majone, “The Rise of Statutory Regulation in Europe,” in Majone (ed.), *Regulating Europe* (London: Routledge, 1996), p. 47. See also: Gilardi (2003, 2004).

²² Majone 1996, p. 49.

has never been as strong in Europe as it has in the United States. Indeed, cartels and restrictive agreements were traditionally accepted either as an expression of the freedom of contract, as in Britain, or as instruments of rationalization and industrial policy, as in Germany.”²⁴

Finally, the institutional proclivities of Europe and China (and East Asia, but in contrast to the U.S.) make the comparison valid. In Europe, notably in France and Germany, the tradition of state intervention and state sponsorship and/or support of cartels, often realized in the ministerial direction of major industries, means that both regions have faced problems of extricating bureaucratic and sectoral interests from the regulatory area. The rise of the European Union as a supranational level regulator has ameliorated this pressure somewhat on the continent. As will be shown below, however the long shadow of the former bureaucrats plays out in China much as it has in the countries of Europe.²⁵

Thus, although there is much to be learned from the experience of the developmental states in East Asia about China’s move toward being a “regulatory state,” the European experience may be even more useful. All three areas – Europe, developmentalist East Asia, and China – share institutional and normative traditions that stand in stark contrast to the United States, despite (ironically) the influence of the U.S.-based independent regulator model. Europe is more useful, though, in that it shares with China a much greater effort, in form, to adopt the model of the independent regulator, in contrast to the rather weak efforts toward this end in Japan and Korea.

²³ On direct pressure from the U.S. government (including occupied forces) after World War II, see Ginadomenico Majone, “Cross-national Sources of Regulatory Policy-making in Europe and the United States,” *Journal of Public Policy*, Vol. 11, no. 1 (1991), pp. 79-106.

²⁴ Majone, 1996, p. 50.

²⁵ See, for example, the discussion of the remaining distinctiveness, along *dirigiste* lines, of the French model of capitalism, despite pressures for and discussion of greater convergence with the Anglo-Saxon model, in Ben Clift, “The French Model of Capitalism: *Still Exceptional?*,” in Jonathon Perraton and Ben Clift (eds.), *Where are National Capitalisms Now?* (Hampshire, UK: Palgrave, 2004), pp. 91-110.

The “Tiers” of China’s Regulatory State

It seems that many analyses of China’s political economy overlook a very fundamental fact: that China’s economy, always complex, has become increasingly so. As a continental economy engaged in a huge range of activities, it is hard to characterize *the* economy or *the* political economy. Nor does it contain *one* clear model of regulatory state.

It is more useful, indeed, to think of China’s political economy, and its system of economic governance, as having three tiers.²⁶ The top and low tier are the easiest to characterize. The exclusive top tier is made up of China’s “lifeline” (*mingmai*) or “commanding heights” industries. It is made up of what tend to be the largest companies, and those that the government considered “strategic.” A key measure of “strategic” is whether their majority assets have been placed under the control of the State-owned Assets Supervision and Administration Commission (SASAC). The government, while wishing to privatize a portion of the assets of these companies, primarily in order to raise revenues and (perhaps) gain international legitimacy, intends to maintain dominant ownership and, especially, control of these firms. Most of these firms, in addition to being on SASAC’s list of 196 companies, are also overseen by the NRDC. At the same time, most also have been subject to an “independent” regulator. Examples include the companies in the fields of electric power, telecommunications, oil, banking, and securities.

The slogan “*zhua da fang xiao*” (grasp the big, release the small), endorsed at the 1997 15th Party Congress, captures the effort to focus state assets in large state firms, ideally getting

²⁶ This essay is my first attempt to write about this notion of a “tiered economy” and “tiered regulatory state.” Apologies for its sketchiness. Comments and suggestions – including to other sources – are most welcome. The notion of three tiers shares some similarities with Studwell’s depiction of “parallel economies.” However, he focuses on the state economy (as opposed to the private economy) as reflecting a failure to dismantle the old economy, whereas I would characterize the state economy, primarily the “top tier” as reflecting an effort to

rid of poorly performing assets in these large firms, and at the same time spinning of (selling or consolidating through mergers) medium and small enterprises. It is important to emphasize that it is not, as often characterized, bureaucratic inertia and vested interest that keeps the state owned sector alive. Rather, it reflects a conscious effort by the Chinese government to concentrate and consolidate this top tier as a key part of China's development strategy. The fundamentally developmentalist strategy is reminiscent of Japanese and South Korean industry groups.

The low tier (low because of the firms' place in a regulatory hierarchy) is constituted by the vast majority of China's private and collective firms. It also contains many of the country's approximately 90,000 smaller state firms, some of which are sold to private or foreign investors. Many of these firms are being leased to existing management, or turned into joint stock companies with a mixture of government and employee ownership.²⁷ The firms in this tier tend to be small-scale, and engage in personal services and the sale and manufacture of consumer goods and other light industries. They are the majority of China's export-oriented firms. (I also put the coal-mining industry in this category.) In general, they are not the subject of industrial policy, and are not subject to oversight by a sector specific independent regulator. However, they are of course subject to government rules (such as for licensing) and, increasingly, to social regulation designed for consumer and worker protection.

The proposed middle tier is admittedly hardest to characterize. I conceptualize it based on China's automobile industry (so perhaps is an n of 1).²⁸ It has an industrial policy – indeed, automobiles was the first of China's "pillar" industries, named in 1994. But at the same time, there has been recognition that the auto industry has to be deeply integrated into a global supply

reconstitute the former state sector. Joseph Studwell, *The China Dream* (New York: Atlantic Monthly Press, 2002), pp. 219-244.

²⁷ Studwell (2002), p. 236.

chain if it is to succeed. Moreover, autos are retail goods. These two latter factors have led the central government to be more hands off than in the cases of the lifeline industries.

Figure 1. Summary characteristics of the three tiers of China’s political economy

	Top Tier	Middle Tier	Low Tier	
Types of Industry	Most strategic (e.g., electric, telecom); financial services	Automobile	Service and light manufacturing; export	
ownership	Majority, mostly central govt and domestic but w/ some shares on stock markets	Usually state, but often w/ significant local interests; Geely (Zhejiang) is private.	Private/collective, but also a large portion of China’s smaller state firms.	
SASAC supervises assets?	Assets overseen by SASAC	Assets overseen by SASAC (local SASAC branch where firm is municipally owned)	Not SASAC	
Type of regulator	Independent regulator in most cases, ²⁹ geared to specific sector, w/ close oversight by central authority (NRDC)	Not regulated as a specific sector by a central authority;	Little oversight beyond local SAIC	
Economic vs. social regulation	Economic	Economic	social	
Goals of regulation	Industry structure provides some, but not too much, competition; maximize state revenues and assets			
Industrial policy?	Yes	Yes, for auto, by NRDC		
State management	SASAC appoints top management	??	??	

²⁸ In other words, the middle tier at present has an n of 1.

²⁹ Oil is an exception – there is no independent regulator in the China’s oil business.

What is the State of Play of Regulation in China's Tiered Economy?

Regulatory Characteristics of the Top Tier

Regulation in the top tier has been characterized by the establishment of a group of new regulatory bodies.³⁰ The new bodies in some ways filled a bureaucratic space left by the organizational restructurings of 1998 and 2003. China has established regulatory commissions governing key infrastructure sectors (electric power, telecommunications, and aviation) and financial services (securities, insurance, and banking). The regulators are listed in Figure 2. The oil sector is a crucial exception. As indicated in Figure 2, most of these regulators were carved out of or morphed from previous ministerial level agencies. While some started at the vice-ministerial level, all now have ministerial status. Concomitant moves by the state to reform corporate governance has meant there has been substantial efforts to separate these regulators from the businesses they regulate, and from the businesses that used to be part of the regulators' own ancestry. (For example, the insurance regulator's former ministerial persona, the Bank of China, also previously had direct control over the largest insurance company, and the company with former monopoly power – People's Insurance Company of China [PICC].) These efforts to separate regulator from firm have, over time, gained more and more credibility.

Figure 2. China's New Top Tier Regulators

<u>Name of Regulatory Body</u>	Industry scope	Year established	Formed out of which institution?
China Securities Regulatory Commission (CSRC)	Financial services: securities	1992	People's Bank of China
Ministry of Information Industry (MII)	Telecommunication & information	1997	Ministry of Post & Telecom, Ministry of

³⁰ Analysis of regulation in strategic industries is found in Margaret M. Pearson, "The Business of Governing Business in China," *World Politics* (January 2005).

			Electronics
China Insurance Regulatory Commission (CIRC)	Financial services: Insurance	1998	People's Bank of China
General Administration of Civil Aviation (CAAC)	Aviation	2002	CAAC (prior to restructuring)
State Electricity Regulatory Commission (SERC)	Electric Power	2003	Ministry of Electric Power
China Banking Regulatory Commission (CBRC)	Financial services: Banking	2003	People's Bank of China

Yet, as noted in the introduction, a number of bureaucratic and institutional features of the Chinese system have prevented the independent regulator model from being fully articulated, and in particular have prevented independence of the regulators from “politics” from becoming a reality.

In terms of institutional design, two main gaps with the independent regulator model are most evident. First, supra-regulatory bodies remain exceptionally powerful. These include, in the main, the NRDC and SASAC. NRDC still is the source of most industrial policy, and moreover approves major investments and industry decisions. SASAC has substantial authority over assets, including the privatization, sales and purchases of businesses and business units, and the appointment of top managers. These institutions have good reason to be involved, for they remain responsible for overall economic performance of the economy and its most strategic sectors. And they serve as the source of much regulatory policy – a function that legislatures may serve in Western economies. The main dysfunction arising from the presence of supra-regulatory authorities is that their function vis à vis the formal regulators is poorly defined, and their power can in effect trump that of the regulator. This poor definition of regulatory functions has served to keep the regulators relatively weak.

The weakness of regulators is further exacerbated by a second institutional feature: their need to continue to compete with other agencies that have never lost full authority over regulating a particular sector. The telecom sector provides the most egregious example, with at least ten other government bodies (including Ministry of State Security) retaining a say over telecom decisions.³¹ Much more than in Japan, in fact, regulatory decision making thus in China's top tier remains fragmented and contested, and the coordination that must occur in fact between these multiple contestants leads to a very fragmented and poorly enforced regulatory regime.

Thus, the attempt to add in new institutions, processes and ideas, and even to eliminate some of the old hindrances, has not created a seamless transformation to a brand-new system of economic governance. Rather, the new system has been grafted onto the rest of the system – but not granted sufficient, or sufficiently delineated, authority. The extremely fragmented politics characterized by protracted bargaining between interested bureaucracies remains a fact of political life, as does the hyper-conscious attention to formal government hierarchy and a unit's positioning in it.

In addition to these institutional features emanating from China's former planning system, the current regulatory environment contains normative preferences to limit competition (by managing industry structure) and to name winners. Indeed, the upper echelons of the party-state retain a keen interest in the performance of the state-owned firms on which it has banked much of its vision for the future of China's economy, as well as much of its own legitimacy. This keen interest means it must care which firms survive – leading to continual efforts to optimally structure the market and avoid what it perceives to be wasteful competition. One clear

³¹ On the same phenomenon in food regulation, see below.

result of the desire to avoid “excessive” competition is that the state has actively structured the industries, breaking up the former monopolies into four or five pieces, rotating assets in and out of them like a shell game in order to optimize the structure. (In the case of the civil aviation sector, a massive breakup of CAAC came with radical deregulation, but it was followed by a reorganization into a small number of large airlines.³²) Figure 3 depicts the current industry structure. Rumors are rife that in telecommunications, one of the major firms – probably China Mobile, which is generally considered “too big” -- will be further broken up and folded into another of the existing companies, leaving three dominant players.³³ NRDC and SASAC are the dominant actors in these matters, which involve decisions not only about industry structure and disposition of state assets, but also the allocation of technical modalities (CDMA vs. GSM) between state firms, as well as the choice of both Chinese and foreign partners in an upcoming CDMA joint venture.

Figure 3. Market Structure of Strategic Industries

Industry	Dominant players dominated by state-ownership?	Number of dominant players
Telcos	yes	4
Aviation	yes	3
Electric power grid	yes	2
Electric Power generation	yes	5
Securities	yes	Many; 8-10 planned
Insurance	yes	20
Banking	yes	4

³² Jae Ho Chung, “The Political Economy of Industrial Restructuring in China: The Case of Civil Aviation,” *The China Journal* 50 (July 2003).

³³ One of these players will then be awarded a license for CDMA technology (to be a JV) and the other two will be GSM. This reorganization is expected prior to October 2006, when some crucial WTO commitments in telecom will be phased in.

Regulatory Characteristics of the Middle Tier/Auto Industry

As noted previously, the middle tier is modeled on China's automobile sector, and at this point it is the sole industry in that tier. The following discussion therefore focuses on the auto industry (with the hope of expanding it if the idea of this tier can be sustained).³⁴ Unlike the industries (except oil) in the first tier, a sector-specific regulator does not oversee China's auto industry. Nevertheless, the industry is governed by industrial policy, first promulgated by the State Planning Commission in 1994. This policy dictated that China would have 3-4 major auto manufacturers. To this end, the comprehensive planning bodies, particularly NRDC, have had a strong say in deciding which companies should become "national champions," and which should merge. As with the firms in the first tier, the huge investment and economies of scale required to produce autos at least in part dictate this attention. Yet at the same time the industry contains significant ownership and control at the municipal level (Shanghai and Beijing municipal governments), as well as one substantial private firm (Geely).³⁵ SASAC does oversee the assets of the large centrally owned auto producers. The municipal SASAC branches oversee those firms owned by Beijing and Shanghai municipal governments.

What most distinguishes auto industry policy from the industries in the top tier is that there was, early on, a recognition that much of the supply chain for China's auto industry would have to be globalized, and that joint ventures were necessary. In other words, it made sense to have the government structure the industry but not to hold these assets as if they are "strategic" in the manner of oil and electric power. More leeway was to be given to the firms. Why? Three

³⁴ See Eric Thun, *Changing Lanes in China* (Cambridge University Press, 2006).

³⁵ FAW (Changchun, belongs to the center). SAIC & BAIC are owned by Shanghai and Beijing municipal governments, respectively.

factors seem relevant. First, is the recognition that the auto sector could not succeed without being integrated into the global supply chain and without joint ventures. This recognition was not automatic, of course, as local content goals were a huge part of the early discussions for joint ventures. Shanghai municipality in particular worked hard and with some success to develop a local supply chain.³⁶ Yet over the years Chinese government efforts to enforce Chinese production of inputs for auto JVs has waned, or relaxed, considerably. Second, perhaps because the government could not control consumer demand, they acquiesced in the idea that more of the auto industry would be market driven. (There have been substantial efforts to close foreign firms out of distributorships, however.) Third, because municipalities have a significant role in development of the industry, the center appears to have yielded the notion of comprehensive authority. As a result, industrial policy has been aimed aggressively at creating national champions, but (with the exception of FAW in Changchun), the term national champion is won more through competition and consolidation of existing firms than designation from the top. In short, the hyperintensity of regulation in this sector is less than for the strategic industries.

Regulatory Characteristics of the Low Tier

The vast majority of Chinese businesses in terms of numbers – notably, medium and small manufacturing, personal services, and retail - are not regulated in the way that the “lifeline” firms and the automobile sector are. During the reform era they have either sprung up

³⁶ Adam Segal and Eric Thun, “Thinking Globally, Acting Locally: Local Governments, Industrial Sectors, and Development in China,” *Politics and Society*, Vol. 29, No. 4 (December 2001), pp. 557-588.

outside the direct view of the central state or, if previously existing, have moved out of the cross hairs of the comprehensive regulatory agencies.³⁷

These firms are not subject to efforts at economic regulation, which makes sense to the extent that these firms are not natural monopolies. They are subject to rules and regulations aimed at giving the state approval rights for business scope and operations. These include, emanating from the central level, permit and license requirements for entering and expanding businesses, capital requirements, lists of business areas in which private capital is forbidden, and numerous other restrictions originating at the local level.³⁸ There are also major restrictions on the access of these firms to bank capital and the ability to be listed on stock exchanges.³⁹ The major “regulatory agency” to oversee matters of market regulation for most Chinese enterprises is the State Administration for Industry and Commerce (SAIC), a bureaucracy charged with stabilizing the market and also combating local protectionism. SAIC’s operations were centralized from the local level to the provincial level in the late 1990s⁴⁰, yet it is far from being an independent regulator on the model of those in the strategic industries.

On the other hand, these small and medium enterprises, as well as other industries we can categorize in the third tier, are increasingly subject to social regulations designed to protect consumers from fraud, overpricing, and discrimination, as well as to protect workers. Indeed, led particularly by high profile cases of pharmaceutical fraud, Ponzi (pyramid) schemes, and workplace accidents, and driven by popular demand and media attention, social regulation has

³⁷ Many in this category are, of course, township and village enterprises begun and often still existing under the purview of local governments.

³⁸ These “negative” regulations are well summarized in Studwell (2002), pp. 228-231.

³⁹ On finance difficulties for small and medium firms, see: Huang, Yasheng, *Selling China: Foreign Direct Investment During the Reform Era* (New York: Cambridge University Press, 2003); and Kellee Tsai, *Back Alley Banking: Private Entrepreneurs in China* (Ithaca: Cornell University Press, 2002).

⁴⁰ See Andrew Mertha, “China’s Soft Centralization: Shifting Tiao/Kuai Authority Relations,” *China Quarterly* No. 184 (2005), pp. 791-810

taken on great importance in China in the past decade. This is not to say that such regulation is effective, but that institutions for and attention to social regulation has skyrocketed. Two areas for such regulation are notable. The first is the establishment of the State Food and Drug Administration (SFDA, modeled on the U.S. Food and Drug Administration), which has been at the forefront of pharmaceutical and, more recently, food labeling fraud. The fake baby formula scandal of the 1990s, which led to numerous deaths among infants, was a major spur for this institutional development⁴¹ A second is the efforts to regulate coal mine safety through the State Administration of Coal Mine Safety (established in 1999). Deaths from coalmine accidents have received tremendous publicity within China in the past decade, spurring regulation. Both regulators are designed to be separate from the administrative segments of the state that long were involved in production (“independence from business”).⁴²

In the case of social regulation in China, we see an interesting dynamic whereby the main perpetrators of abuse are seen to be local governments and their enterprises. The central government has been at the forefront of reform in terms of protecting workers and consumers by reining in local officials and local state firms. Interestingly, much of the authority for actual implementation has redounded to the provincial level offices of these national agencies – moreso than in the case of the strategic regulators.⁴³ Nevertheless, in their early years fragmentation and poor definition of regulatory authority, as well as spotty implementation have marred these regulation efforts.

⁴¹ Waikeung Tam and Dali Yang, “Food Safety and the Development of Regulatory Institutions in China,” *Asian Perspective*, Vol. 29, No. 4 (2005), pp. 5-36.

⁴² See: Fubing Su, “Political Economy of Industrial Regulation in China's Coal Industry, 1992-1999,” in Barry Naughton and Dali L. Yang, eds., *Holding China Together* (New York: Cambridge University Press: 2004); and Wang Shaoguang, “Regulating Death at Coalmines: Changing Mode of Governance in China”, *Journal of Contemporary China*, February 2006, pp. 1-30. In the case of coal, the Bureau of Coal Mining was abolished in 2000.

⁴³ See Mertha (2005). Tam and Yang (2005, p. 15) note establishment of provincial level food safety commissions.

Thoughts on the Nature of China's Politico-Economic System: Is it Capitalist?

I have tried thus far to make two basic observations in this paper. First, and very simply, we have to pay attention to the regulatory piece of the puzzle – to the form of economic governance China is establishing – if we are to understand the country's emergent political economy. This makes total sense, as “laissez faire” or a “night watchman” state with regard to the economy was never truly in the cards in China, as it is not taken seriously elsewhere.

Second, when we look at the regulatory piece we see complexity. Different regulatory strategies are being applied to different parts of the economy. I have found it useful to think of the different categories as “tiers,” reflecting to some degree the strategic importance the party-state places on close control of these enterprises. In its strategic industries, the Chinese government has formally established the trappings of an internationalized (from Euro-American experience) regulatory state model. In practice, though, from comparative point of view, what exists is much like the Japanese and Korean developmental states. The state has shown a commitment to hold on to what it hopes will be profitable, and what it deems necessarily to be strategic, industries. It has made a conscious decision that state ownership of key assets, subject to regulators that will help improve the quality of those assets, is the future of the lifeline industries. The state has built a rather elaborate architecture, guided by external models but – unsurprisingly – reflecting the need for continued close monitoring of business decisions. The lower tier of firms looks quite different. The “*fangxiao*” strategy of releasing medium and small state enterprises to the market merely extends what had long in practice been the norm for small private and collective entities. This is not to say there is no regulation, but the model is the early reform era model of licensing requirements, fee-levies, and the like. In the past ten years, this sector has been the focus of social regulation. The middle tier is difficult to characterize, but is

modeled on the auto industry. There, we see that early 1990s industrial policy designed to create “national champions is, far from seen as quaint, still in effect. At the same time, the localized nature of a major portion of the industry (Shanghai Municipality is particularly important) and the globalized nature of the industry, have led the government to a significantly more hands-off approach when compared to the top tier.

It makes sense at this point to ruminate a bit on what the nature of China’s regulatory state can tell us about capitalism in China. We must recognize first and foremost that private ownership, true to party dogma, remains only a segment of the economy. It is an important segment, of course, and may become dominant. Yet, much as in France, state ownership is seen as a long term goal for some industries, and a huge architecture is being built to sustain it and make it internationally competitive. (Whether this architecture is effective is questionable, but not its presence or the goal.) There is an effort to make these state conglomerates more effective by subjecting them to market forces – greater competition, listing of stocks, etc. But we must take to heart Lindblom’s classic caution to separate the concept of markets from that of ownership, and recognize that there are many ways to mix ownership and market systems.⁴⁴ That the Chinese are attempting a hybrid of state ownership-cum-industrial policy-cum-independent regulators is not, given the Chinese and international contexts, too surprising. I would label it is anti-capitalist, though, and call into question our ability to call China “capitalist.”⁴⁵

⁴⁴ Lindblom (1977).

⁴⁵ Foster (1992, pp. 333-365) speaks directly to this point, suggesting that while privatization is preferable, it is not a necessary corollary of regulatory reform.