

**Crossing the River by Feeling for Stones or  
Carried Across by the Current?**

**The Dynamics of Reform in Post-Mao China**

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Paper Presented at a conference on

Capitalism with Chinese Characteristics:  
China's Political Economy in  
Comparative and Theoretical Perspective

Indiana University  
Bloomington, Indiana  
May 19-20, 2006

## Introduction

Scholars of China's post-1978 economic reform confront two seemingly diametrically opposed realities. On the one hand, the Chinese economy has outperformed all expectations, with per capita Gross Domestic Product (GDP) growing a total of over 630 percent between 1980 and 2005 compared to a global average of 53.42%.<sup>1</sup> Stunning economic growth has, on the other hand, also been accompanied by what some see as a surge of dysfunctionality – increasing income inequality, surging corruption, the build up of massive bad debt, etc. The Chinese economy has, according to Pei Minxin: “fallen victim to crony capitalism with Chinese characteristics—the marriage between unchecked power and illicit wealth.” In accord with mainstream economists who assert that rising corruption lowers growth rates, Pei predicts that while the Chinese economy has grown substantially to date, it can only go so far before the underlying problems bring things crashing down.<sup>2</sup> Pei and may be right. But the reality is that dire predictions have been made any number of times before and yet the Chinese economy keeps on rolling.

It might be tempting to dismiss Pei and others who have predicted the demises of the “Chinese economic miracle” as mere “nattering nabobs of negativity.”<sup>3</sup> There is no doubt that reform has spawned a host of negative consequences, including a discernible

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<sup>1</sup> Available at <http://www.imf.org/external/pubs/ft/weo/2005/02/data/index.htm>.

<sup>2</sup> Pei Minxin, “The Dark Side of China’s Rise,” *Foreign Policy* (March/April 2006).

<sup>3</sup> See Gordon G. Chang, *The Coming Collapse of China* (New York: Random House, 2001).

intensification of corruption.<sup>4</sup> Yet to treat “problems” such as corruption as essentially negative consequences misses a central problem in conventional analyses of China’s economic reform: the failure of adequately conceptualize the relationship between reform and its unintended side effects. Problems such as corruption, broadly defined, are conventionally viewed as a consequence of systemic change and hence an exogenous result of reform. In this analysis, I argue that the unintended consequences of reform are actually endogenous to the reform dynamic and that they played a critically important part in driving the economy from the plan to the market.

Herein I do not wish to suggest or imply that unintended consequences such as rent-seeking and corruption have positive benefits or that they were the primary factor driving the reform process forward. Rather what I hope to demonstrate is that given the incremental, ad-hoc nature of policy change, rent-seeking and corruption have helped propel the shift away from a partially decontrolled economy toward a more fully marketized economy. Cast in slightly different terms, I argue that that partial institutional reform transformed incentives structures in ways that called forth unintended and even dysfunctional responses. These responses caused secondary, often informal parametric shifts and these secondary shifts forced tertiary shifts in institutional structures, which themselves evoked further unintended responses. The unintentional consequences of partial reform, in other words, unintentionally forced the reform process beyond the unstable intermediate stages created by a halting and cautious approach to systemic reform and forced more sweeping changes in the system. It was thus the combination of

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<sup>4</sup> Andrew Wedeman, “The Intensification of Corruption in China,” *China Quarterly* no. 180 (December 2004): 895-921.

intentional institutional reforms and unintended responses that animated the reform process and provided its dynamic force.

Theoretically, my argument derives from two sets of literature. The first includes conventional macroeconomic analyses of the effects of artificially created distortions in supply, demand, and prices. Quite simply, this literature suggests that artificially created distortions create a disequilibrium that can only be held in place by external, extra-market constraints. If these constraints are removed or weakened, market forces will drive supply, demand, and price back toward equilibrium.<sup>5</sup> The second theoretical approach comes from the fields of “evolutionary economics” (also known as “institutional economics”) and chaos theory. According to the advocates of these schools, standard economic theory false assumes that systems inexorably seek equilibrium. Evolutionary economists reject this claim, arguing instead that all systems existing in perpetual disequilibrium and are in constant flux. The focus of analysis must, therefore, be on systemic on dynamics and specifically how the contractions inherent in all systems drive differential rates of change and move systems toward or away from certain more stable constructs. By combining simple supply-demand theory with a dynamic evolutionary model, I seek to demonstrate that rent seeking behavior helped drive the reform process and specifically prevented it from stalling out.

To illustrate my argument, I focus on two areas: price reform and enterprise reform, reforms that the Chinese Communist Party (CCP) has shied away from and opted

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<sup>5</sup> See K.K. Fung, “Surplus Seeking and Rent Seeking Through Back-Door Deal in Mainland China,” *American Journal of Economics and Sociology* 46, no. 3 (July 1987): 299-317; Barbara N. Sands, “Market-Clearing by Corruption: The Political Economy of China’s Recent Economic Reforms,” *Journal of Institutional and Theoretical Economics* 145, no. 1 (March 1989): 116-126; and Barbara N. Sands, “Decentralizing an economy: The Role of bureaucratic corruption in China’s economic reforms,” *Public Choice* 65 (April 1990): 850-91.

for half-way measures rather than a sweeping, “big bang” dismantling of the old state controls. In fact, policy reforms in both areas were meant to move the economy not toward the market, but to entrench it part way between the plan and the market. But in both cases, partial reform proved untenable because even limited structural change called forth responses that existing structures could neither control nor contain. As a result, even though the reformers in Beijing sought to retain considerable state control over the economy, in the end the reforms designed to maintain the state’s grip failed and the extent of changes wrought by these limited reforms went far beyond the marks set by their authors.

### **Evolutionary Chaos**

The rationale for endogenizing the unintended consequences of policy shifts and treating them as a dynamic factor in systemic system change derives in the first instance from the work of Jin and Haynes who describe the reform process in China as “a phase transition” that is “evolving, co-evolving, chaotic, self-organizing, path dependent and mutually catalytic,” that produced radical change “at the edge of order and chaos.”<sup>6</sup> More broadly, my rationale derives from “evolutionary economics” and “chaos theory.” Evolutionary economists reject what they deemed to be the “mechanistic” assumptions of mainstream economics and its assumption of equilibrium. Conventionally, economists assume that market activity will develop into stable, coherent patterns (equilibrium) and that these patterns will be sustained until some exogenous shock creates instability and change. Following such a shock, instability and change will continue until the behavior of

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<sup>6</sup> Jin Dengjian and Kingsely E. Haynes, “Economic Transition at the Edge of Order and Chaos: China’s Dualist and Leading Sector Approach,” *Journal of Economic Issues* 31, no. 1 (March 1997): 83-4.

the constituent actors harmonizes and a new equilibrium is reached.<sup>7</sup> Change occurs, therefore, in a punctuated manner wherein equilibrium prevails until there is an exogenous shock to the system that produces periods of disequilibrium. Disequilibrium, however, eventually yields to new equilibrium and the system returns to steady state.

Evolutionary economists argue that economic systems never achieve steady state equilibrium. Stable and repeated patterns are at best partial or imperfect equilibrium. Not only are structures assumed to be imperfect, it is also assumed that the system's actors are constantly probing the system's limits in search of new ways to game the system to their advantage. As a result, change occurs continuously rather than episodically. Marginal change occurs as actors react to imperfections in existing structures seeking to exploit new opportunities or avoid negative outcomes. More dramatic change occurs when systemic parameters either fail or are revised. The magnitude of systemic imperfections affects the magnitude of incremental change. Drawing on chaos theory – or more accurately the idea of “deterministic chaos” – this approach suggests that small imperfections beget behaviors that can swell into forces that produce major or even cataclysmic change. Even small “accidents” (“butterfly fly effects”) may prove to have profound ramifications over the long run because they have the potential to amplify the contradictions in existing structure and the consequences of even small parametric changes in existing structures thereby producing a “Feigenbaum cascade of rapidly accelerating change.”<sup>8</sup>

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<sup>7</sup> Charles M.A. Clark, “Spontaneous Order Versus Instituted Process: The Market as Cause and Effect,” *Journal of Economic Issues* 27, no. 2 (June 1993): 377.

<sup>8</sup> Geoffrey M. Hodgson, “Economic Evolution: Intervention Contra Pangloss,” *Journal of Economic Issues* 25, no. 2 (June 1991): 528; William J. Baumol and Jess Benhabid, “Chaos” Significance,

Thus systems characterized by highly incongruent structures will tend to generate high levels of “dysfunctional” behavior while more coherent systems will tend to generate lower levels of dysfunctional behavior. Even relatively coherent structures are assumed, however, to be subject to decay and vulnerable to revision. In this context, catastrophic systemic change can result not only from exogenous shocks that produce serious instability, but also from the cumulative effects of low levels of endogenous “dysfunctional” behavior. Because internal contradictions and structural flaws drive the overall process, the salience of “bolt from the blue” exogenous shocks is assumed to be marginal and hence the emphasis is on understanding the endogenous sources of dynamic change. Evolutionary economists, therefore, stress the centrality of holistic dynamic analysis, focusing not only on the factors that produce change but how change reverberates over time, producing not only temporary instability, but also how changes cascade over time to cause further change.<sup>9</sup> In such a construct, change is both cause and effect because it occurs in a circuitous chain of causality.

Evolutionary economics thus proposes a model that at least superficially resembles the Marxist dialectic, which assumes that any pattern (the thesis) contains internal contradictions and that these contradictions generate dysfunctional behaviors (the antithesis) that undermine the thesis. The clash between thesis and antithesis ultimately causes systemic shifts that give rise to a new pattern of relative stability (the synthesis). But whereas Marxism assumes a teleological progress toward a more perfect system (i.e.,

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Mechanism, and Economic Applications,” *The Journal of Economic Perspectives* 3, no. 1 (Winter 1989): 77-105; and Michael J. Radzicki, “Institutional Dynamics, Deterministic Chaos, and Self-Organizing Systems,” *Journal of Economic Ideas* 24, no. 1 (March 1996): 67-8.

<sup>9</sup> Irene van Staveren, “Chaos theory and Institutional Economics: Metaphor or Model?” *Journal of Economic Ideas* 33, no. 1 (March 1999): 142.

movement toward full communism), drawing on Darwinian evolutionary theory, evolutionary economics rejects the assumption that change selects “optimal” behaviors. On the contrary, evolutionary economists assume “error making,” as well as reactive behavior that may produce clearly sub-optimal “Pangloss” outcomes.<sup>10</sup> Moreover, contrary to conventional economics, evolutionary economics rejects the notion that sub-optimal responses will be selected out and or that one response will crowd out others.<sup>11</sup> Because outcomes are assumed to be inherently unstable and at best imperfectly sticky, both sub-optimal and seemingly Pareto optimal outcomes are assumed to be transitory and subject to continued revisions. As a result, evolutionary economics accepts a considerable degree of indeterminacy.

Moreover, evolutionary economics explicitly recognizes that systemic dynamics are driven both by structural parameters and the reaction of individual actors to both those parameters and the ongoing struggle among the system’s constituent actors to either maintain or revise those structural parameters. The direction and flow of change is thus largely driven by behaviors that either stabilize or destabilize the system.<sup>12</sup>

Because they recognize that change is at least imperfectly path dependent, evolutionary economics do not, however, assume that change takes place in an anarchic, random fashion. Because feedback drives the dynamic forces of change, all systems are sensitive to initial conditions.<sup>13</sup> Thus in many instances small perturbations may produce

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<sup>10</sup> Hodgson, “Economic Evolution:” 526.

<sup>11</sup> Richard r. Nelson, “Recent Evolutionary Theorizing About Economic Change,” *Journal of Economic Literature* 33, no. 1 (March 1995): 48-90.

<sup>12</sup> David Carrier, “A Methodology for Pattern Modeling Nonlinear Macroeconomic Dynamics,” *Journal of Economic Ideals* 26, no. 1 (March 1992): 226.

<sup>13</sup> Radzicki: 65.

short-term fluctuation but over time the trajectory of change will return to a “chreodic” or “homeothesis” path, that is one whose general trajectory exhibits a broadly orderly evolution over the long run.<sup>14</sup> Even through path dependence may plot out a general “flow” over time, change nevertheless takes place in a “non-linear” manner because it is possible to sharply deviate from the general flow, particularly in the short-term.

Although offering an attractive alternative to “mechanistic” equilibrium analysis, evolutionary economics and the idea of deterministic chaos do not necessarily provide a particularly clear analytic construct for analyzing systemic change. They instead tend to serve up a series of metaphors and concepts that are not easily reduced to an easily articulated “model.”<sup>15</sup> Yet, even as a set of metaphors, the central concepts of evolutionary economics offer a powerful means for describing the dynamics of reform in post-Mao China. In particular, evolutionary economic demands explicit recognition of the reform process as one involving recursive feedback loops and the emergence of partial and transitory “equilibrium” wherein the process unfolds as series of “phases,” each of which is ultimately destabilized by its own internal contradictions in a continuous evolutionary process. In critical respects, in fact, conventional descriptions of these reforms suggest that they can best be understood not in linear terms but that in terms of a nonlinear, frequently chaotic process of continuous change wherein the Chinese economy is evolution away from its pre-reform structure and toward a more marketized structure but in complex and often indeterminate manner.

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<sup>14</sup> Hodgson, “Economic Evolution:” 528.

<sup>15</sup> This imprecision seems aptly captured by Carrier when he seeks to summarize the overall thus the evolutionary and chaotic ideas by arguing that: “The pattern undergoes continuous evolution and can be likened to the interweaving of melodies in a symphony, which may be harmonious and synchronized, rising or diminishing, or cacophonous...” Carrier, “A Methodology for Pattern Modeling:” 227.

### Ad-hoc Reform

Most analysts characterized the reform in China process as “ad-hoc.” This is hardly surprising. Chen Yun, after all, famously described China’s reform process as a steady but cautious “crossing the river by feeling for the stones.”<sup>16</sup> Chen’s description has thus become the foundation for the conventional wisdom about China’s post-1978 approach to economic reform. According to Griffin and Khan:

The reform process has been highly pragmatic, experimental, and sequential. Reform has proceeded by trial and error on a step by step basis. Politics have been flexible, amendments have been frequent, enforcement has been uniform, and reverses have occurred... Indeed, one of the lessons from China is the advantage of proceeding in a flexible and incrementalist way.<sup>17</sup>

Naughton argues that while China’s reforms lacked a “strategy” in the sense of a “conscious design of the sequence of reforms,” or *a priori* guiding principles, reform was not “purely fortuitous” and “crucial government decisions and commitments were required...” The result was an “interaction between government policy and the often unforeseen consequences of economic change.” *Ex post facto* a coherent reform process emerged from this interaction, not as a result of “the policies of Chinese leaders,” but because “there is a generally consistent logic to the way” a planned economy dissolves.<sup>18</sup> Elsewhere, Naughton and McMillian argue that reform in essence cracked open the monopolistic structures that were the hallmarks of the Maoist economy and set off an

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<sup>16</sup> Kwok-sing Li (compiler) and May Lok (translator), *A Glossary of Political Terms of the People’s Republic of China* (Hong Kong: The Chinese University Press, 1995): 281.

<sup>17</sup> Keith Griffin and Azizur Rahman Khan, “The Chinese Transition to a Market Guided Economy,” *Contention* 3, no. 2 (Winter 1994): 86.

<sup>18</sup> Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993* (New York: Cambridge University Press, 1996): 7 and 309.

“irreversible” process of evolutionary change.<sup>19</sup> Chen, et. al. describe the process as a deliberate but implemented in a “piecemeal” manner in which “enabling reforms” removed restrictions on local innovation and legitimated “spontaneous” locally initiatives post-hoc rather than leading the process through top-down policy innovation.<sup>20</sup> Similarly, Fewsmith argues that national policy had a critical effect on the reform process: “Time and again, policy makers... intervened to make critical decisions to speed up, slow down, or change the direction of reform.”<sup>21</sup> Yang also argues that at critical junctures top down policy shifts pushed the reform process forward and that it was the central government’s residual strength that prevented the process from stalling out.<sup>22</sup>

Others believe policy makers had little control over the process. Breslin, for example, describes the reforms as a “dysfunctional agglomeration of numerous local initiatives” rather than the result of “the plans and strategies of the national level decision-making elites.”<sup>23</sup> Zhou, Yang, and Kelliher characterize reforms in the rural sector as nothing less than a spontaneous, bottom up revolution.<sup>24</sup> Woo, finally, suggests that the notion that China’s ad-hoc reform process can be called “a strategy” is perhaps

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<sup>19</sup> John McMillan and Barry Naughton, “How to Reform a Planned Economy: Lessons from China,” *Oxford Review of Economic Policy* 8, no. 1 (Spring 1992): 130-143.

<sup>20</sup> Kang Chen, Gary H. Jefferson, and Inderjit Singh, “Lessons from China’s Economic Reforms,” *Journal of Comparative Economics* 16, no. 2 (June 1992): 214-5.

<sup>21</sup> Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (East Armonk, NY: M.E. Sharpe, 1994): 6.

<sup>22</sup> Dali L. Yang, *Remaking the Chinese Leviathan: Market Transformation and the Politics of Governance in China* (Stanford, CA: Stanford University Press, 2004): 292-298. Yang also asserts that after Deng’s Southern Tour, reform was no long a process of “feeling the stones.”

<sup>23</sup> Shaun G. Breslin, “China: Developmental state or dysfunctional development,” *Third World Quarterly* 17, no. 4 (December 1996):

<sup>24</sup> Kate Xiao Zhou, *Freeing China’s Farmers: Power of the People* (Boulder, CO: Westview, 1996); Dali L. Yang, *Beyond Beijing: Liberalization and the Regions in China* (New York: Routledge, 1997); Dali L. Yang, *Calamity and Reform: in China: State, Rural Society, and Institutional Change since the Great Leap Forward* (Stanford, CA: Stanford University Press, 1996); and Daniel Kelliher, *Peasant Power in China: The Era of Rural Reform 1979-1989* (New Haven, CN: Yale University Press, 1992).

even farcical, writing that the form of gradualism it practiced was akin "...to a person putting one leg into the pants and then stopping for a meditative smoke because he is insecure about whether he would not be better off with a fig leaf or a loincloth."<sup>25</sup>

While there may be disagreement about the extent that top-down policy reforms or bottom-up spontaneous initiative drove the reform process, there is general agreement that reform has produced a host of unintended consequences. Duckett, for instance, finds that state agencies responded to reform by becoming entrepreneurial and setting up business to take advantage of emerging market opportunities.<sup>26</sup> Oi and Walder argue that decentralization shifted power from the center to its erstwhile local agents and transformed local governments into "market-oriented agents" who used "local state corporatism" to create collusive local developmental alliances.<sup>27</sup> According to Boisot and Child, reform has transformed China from a command economy composed of an agglomeration of semi-autarkic "fiefs" into a semi-marketized "network" of "clans."<sup>28</sup>

Wank finds that reform led to an intensification of clientalism and the forging of new "neomercantilist corporatism" that linked the local state to "cadre entrepreneurs" and created an economy characterized not by the chaos of a partially marketized

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<sup>25</sup> Wing Thye Woo, "The Art of Reforming Centrally Planned Economies: A Comparison of China, Poland, and Russia," *Journal of Comparative Economics* 18, no. 2 (June 1994): 906.

<sup>26</sup> Jane Duckett, "The emergence of the entrepreneurial state in contemporary China," *The Pacific Review* 9, no. 2 (1996): 182.

<sup>27</sup> Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley, CA: University of California Press, 1999): 191 and Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy," *The American Journal of Sociology* 101, no. 2 (September 1995): 267-8. Also see Victor Nee, "Organizational Dynamics of Hybrid Transition: Hybrid Forms, Property Rights, and Mixed Economy in China," *Administrative Science Quarterly* 37, no. 1 (1992): 1-27.

<sup>28</sup> Max Boisot and John Child, "From Fiefs to Clans and Network Capitalism: Explaining China's Emerging Economic Order," *Administrative Science Quarterly* 41, no. 4 (December 1996): 600-28.

economy, but rather a relative stable system based on particularism.<sup>29</sup> Gore also believes that reform gave rise to a form of “market communism” in which “bureaucratic entrepreneurialism” has compartmentalized the economy and fueled “massive corruption.”<sup>30</sup> Root goes further arguing that reform has created an “intermediary form of bureaucratic capitalism” in which corruption has become an entrenched bureaucratic right.<sup>31</sup> According to Hao and Johnston, incremental reforms created a series of “squeeze points” that allowed officials to manipulate imperfect markets to their corrupt advantage and that these corrupt interests have become so entrenched that the reform process will eventually ossify.<sup>32</sup> Prybyla, however, sees the combination of incomplete reform and rising corruption as creating a threat that reform could in fact be “undone,<sup>33</sup>” while Peng believes that reform could become bogged down as the local beneficiaries of what he sees as a “corrupted” semi-marketized system resist pressure for the deepening of reform and the weakened stature of the central government limits its ability to force key policy changes.<sup>34</sup>

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<sup>29</sup> David L. Wank, *Commodifying Communism: Business, Trust, and Politics in a Chinese City* (New York: Cambridge University Press, 1999): 225-31.

<sup>30</sup> Lance L.P. Gore, *Market Communism: The Institutional Foundation of China's Post-Mao Hyper-Growth* (New York: Oxford University Press, 1998). Also see Scott Roselle, Albert Park, Jikun Huang, and Hehui Jin, “Bureaucrat to Entrepreneur: The Changing Role of the State in China's Grain Economy,” *Economic Development & Culture Change* 48, no. 2 (January 2000): 227-52.

<sup>31</sup> Hilton Root, “Corruption in China: Has it Become Systemic?” *Asian Survey* 36, no. 8 (August 1996): 741-757.

<sup>32</sup> Michael Johnston and Yufan Hao, “China's Surge of Corruption,” *Journal of Democracy* 6, no. 4, (October 1995): 80-84 and Yufan Hao and Michael Johnston, “Reform at the Crossroad: An Analysis of Chinese Corruption,” *Asian Perspective*, 19, no. 1 (Spring-Summer 1995): 117-49.

<sup>33</sup> Jan S. Prybyla, “China's Economic Reforms: A Synoptic View,” *Journal of Northeast Asian Studies* 15, no. 1 (Spring 1996): 69-88.

<sup>34</sup> Mike W. Peng, “Modeling China's Economic Reform Through an Organizational Approach,” *Journal of Management Inquiry* 5, no. 1 (March 1996): 45-59.

The problem with these characterizations is not so much whether “local state corporatism” or “market communism” more accurately describes that state of the Chinese economy. Rather the problem is that at best there sorts of characterizations tend to yield static “snap shots” of what evolutionary economics suggests is actually an ongoing dynamic process. Market communism or “market Leninism,” therefore, may be only a transitory phase, not an outcome or even a temporary equilibrium. Similarly, these sorts of descriptions often yield contradictory characterizations. While a number of scholars have found evidence of developmentalist “local state corporatism,” for instance, others have found wide spread state predation, albeit under different circumstances but also leading different analysts to radically different conclusions about the trajectory of reform.<sup>35</sup> More generally, there seems to be a tendency to assume that the unintended consequences of reform are likely to take deeper root and thus produce mutant economic systems that lie some where part way between the plan and the market.

Kennedy, however, suggests an alternative view, arguing that unintended consequences of reform may not be consequences but rather “symptom[s] of economic change...<sup>36</sup>” In other words, the unintended consequences of reform are both effect and cause. That is, they are a response to top-down, ad-hoc policy changes and the cause of secondary systemic change. Secondary systemic change, in turn, creates new disjuncture between policy and reality, thus generating pressures for additional policy shifts: additional top-down policy shifts that will, in turn, call forth further unintended responses.

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<sup>35</sup> Thomas P. Bernstein and Xiaobo Lu, *Taxation without Representation in Contemporary Rural China* (New York: Cambridge University Press, 2003) and Elizabeth J. Remick, *Building Local States: China During the Republican and Post-Mao Eras* (Cambridge, MA: Harvard University Press, 2004).

<sup>36</sup> Scott Kennedy, “Comrade’s Dilemma: Corruption and Growth in Transition Economies,” *Problems of Post-Communism* (March/April 1997): 28.

Thus, in the words of McMillan and Naughton, “reform begets further reform.”<sup>37</sup> The reform process is not, therefore, either a top-down or bottom-up process, but rather one in which top-down and bottom-up process interact in a complex fashion that has driven the political economy of China away from the artificial structures cobbled in place during the Maoist era and toward a new more marketized system, but one whose structure is as yet under-determined. Nor is the process of reform a dialectical process defined by discreet transitional stages. It is instead better understood as a chaotic and continuous process of phase transition wherein the Chinese economy is moving away from the imperfectly planned command economy of the Maoist era and is now moving toward a new order in which markets play an increasingly dominant, but not necessarily exclusive role, in structuring economic activity.

### **From Local Protectionism to Price Wars**

The extent to which the “unintended consequences” of ad-hoc reform are actually transitory and causal is amply illustrated by an analysis of “local protectionism.”<sup>38</sup> A

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<sup>37</sup> McMillan and Naughton, “How to Reform a Planned Economy:” 141.

<sup>38</sup> Over the years, the term “local protectionism” has become something of a catchall term for a variety of behaviors that privilege local interests over broader interests. An important distinction must be made, however, between what we can term “horizontal” local protectionism and “vertical” localism. The former encompass local government attempts to segment the market and protect local economic interests from outside competition. The latter includes local authorities’ efforts to wrest an illicit degree of autonomy by blocking outside monitoring and regulation of local policy implementation. Abstractly, both are forms of “localism.” The key distinction, however, lies in the fact that horizontal local protectionism is rooted in the market whereas vertical local protectionism occurs within a bureaucratic context. Horizontal local protectionism thus seeks rents by inducing a variety of administratively induced distortions that favor local economic interests. Vertical local protectionism, by contrast, is essentially political because it represents the usurpation of a superiors’ authority by a subordinate or the abrogation of the agent’s assigned responsibilities. Horizontal and vertical protectionism are not, of course, strictly separate. In fact, vertical protectionism is necessary for horizontal local protectionism because unless a local government usurps the authority granted it as an agent of the central government and thereby secure a degree of illicit local autonomy, it would be difficult for it to improperly privilege local economic interests. Nevertheless, vertical local protectionism can occur absent local rent seeking

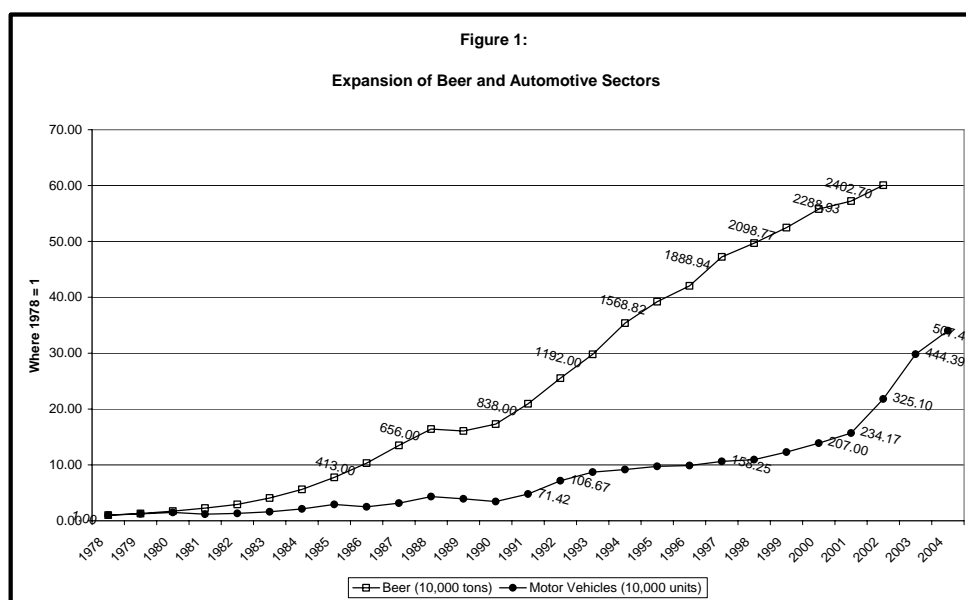
direct and logical consequences of a combination of partial price reforms which created a series of rents, fiscal decentralization which gave local governments incentives to seek these rents, and a partial market reforms than allowed local governments to monetize and capture these rents, local protectionism flourished during the late 1980s, particularly during the recession of 1989-90. In the early 1990s many of its most overt manifestations seemed to disappear as the economy bloomed. When the economy began to slow in the later 1990s, many of the sectors in which local protectionism had been wide spread in during the earlier bad economic times experienced vicious prices wars as producers sought desperately to unload unsold inventory. Although the use of administrative power to protect local interests and aggressive, cut throat discounting may seem logically opposite responses to deteriorating market conditions the shift from local protectionism to price wars flowed directly from shifts not only in the ability of local governments to interfere in the market but also from shifts in the relationship between local governments and local enterprises.

To illustrate my claim, I focus on the beer and automotive sectors. I select these sectors for three reasons. First, beer production is a quintessential light industrial sector characterized by relatively low capital costs and hence relatively low barriers to entry. The automotive production, on the other hand, is a heavy industrial, capital intensive sector with relatively high barriers to entry but is also a “prestige” sector. Second, both sectors are dominated by state-owned enterprises and hence firms that we assume *a priori* have intimate connections to local governments. Third, both sectors underwent tremendous expansion during the reform period (see Figure 1). In the case of the beer

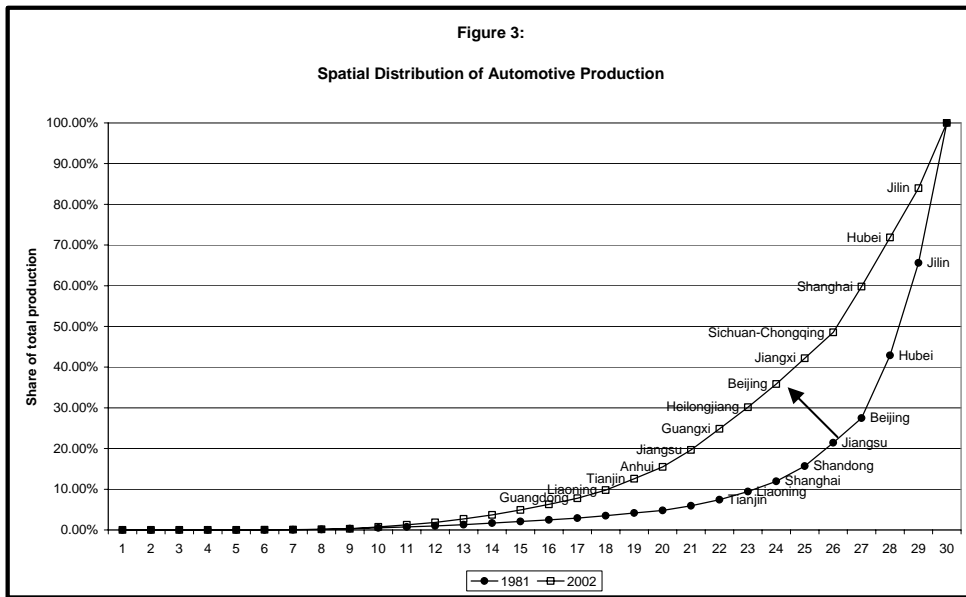
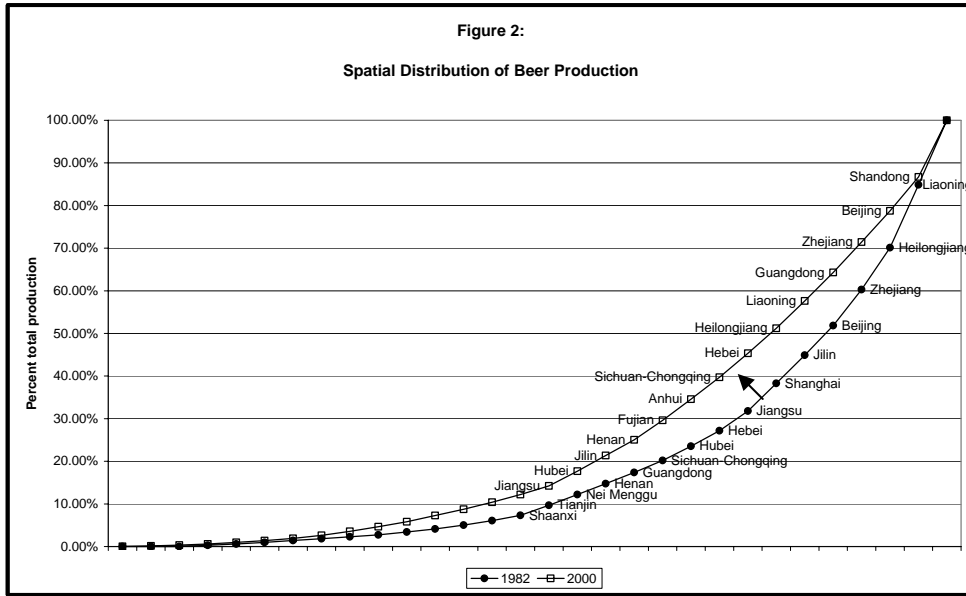
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(and frequently does). These two forms of local protectionism must, therefore, be considered distinct forms of localism.

sector, this included not only substantial increases in total output, but also by a proliferation in the number of breweries, with the total rising from roughly 90 to over 850.<sup>39</sup> Fourth, both sectors are characterized by a combination of widely dispersed production but also significant levels of spatial concentration, as well as not insignificant shifts in the spatial distribution of production (see Figures 2 and 3). Fifth, during the early reform period, both sectors were characterized by high rates of profit. In sum, the beer and automotive sectors exhibit a series of characteristic that would lead us to expect aggressive action by local government seeking to advance the financial interests of local firms and thereby their own financial interests.



<sup>39</sup> *Financial Times (London) (FT)*, 3/27/00 and China Food Technology, “The Brewery Industry Takes New Shape,” <http://www.cnfoodtech.com> and *SCMP*, 7/8/00. As of 2001, China in fact had one brewery for every three counties. *CO*, 1/25/02.



Local protectionism did, in fact, appear in the beer sector relatively early in the reform period. In Sichuan, for example, the number of breweries increased from one in 1975 to 26 in 1988 and 43 in 1990. Installed capacity, therefore, rose to 500,000 tons annual. Demand, however, remained at just 250,000 tons. Faced with a glut of beer, local governments throughout the province banned imports or imposed heavy “surtaxes” on

non-local brew.<sup>40</sup> During the 1989-90 recession, the beer glut became generalized and a host of new import bans were imposed. Jilin banned the sale of beer made in Liaoning and Heilongjiang. Tianjin blocked the sale of Hebei beers. The municipal government in Nanjing banned imports of beer from neighboring counties, while counties in southern China imposed a 20 percent “dumping tax” on “imported beers.” Local governments in Heilongjiang imposed heavy new taxes on all beers, but then rebated the tax for locally produced beers. In Liaoning and Hubei local governments fined stores that sold beers made in other provinces.<sup>41</sup> Despite reductions in the intensity and visibility of internal restrictions on inter-regional sales of beer during the early 1990s boom, the Chinese beer market was reportedly so balkanized in the mid-1990s that foreign brewers declared that it was simply impenetrable because the informal alliance between local governments and local breweries were so strong.<sup>42</sup>

While foreign investors were abandoning the Chinese beer market in despair, China’s major brewers were adapting to market balkanization by “jumping over” local trade barriers. Rather than try to force their way into new markets, companies like Qingdao began buying up local breweries. In many cases, they would buy a stake in financially troubled breweries, negotiate new arrangements with the local governments who owned a controlling stake, inject new capital into the venture, and then seek to grab new market share. In 1994, Qingdao bought the Yangzhou Brewery, thus giving it access to markets in Jiangsu. It then bought the Hansi Brewery in Shaanxi in 1996. The following year it bought ten additional breweries in Beijing, Shandong, Anhui,

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<sup>40</sup> Wedeman, *From Mao to Market*; 171.

<sup>41</sup> Wedeman, *From Mao to Market*: 163-4.

<sup>42</sup> *South China Morning Post (SCMP)*, 7/8/00; *CO*, 4/10/00; and *NYT*, 5/6/04.

Guangdong, and Heilongjiang. Over the next seven years Qingdao continue to aggressively expand with acquisitions in Hunan, Gansu, and Fujian. By 2004, it was operating a total of 48 breweries in 18 provinces, giving it a 13 percent share of the national beer market.<sup>43</sup>

China Resources Enterprises (a.k.a. Huaran), a Hong Kong-listed “Red Chip” company, was also busy breaking into local markets across China. In 1993, it bought the Snowflake Brewery in Shenyang. Working with South African Breweries (SAB), it then bought additional breweries in Liaoning in 1995 and acquired a stake in the Yatai Brewery in Sichuan and the Chuang Ye Brewery in Jilin. In 1999 it bought Foster’s Tianjin Brewery. During the next several years, Huaran bought breweries in Anhui, Heilongjiang, Sichuan, Hubei, Jilin, Beijing, Zhejiang, Guangdong, and Jiangsu. As a result, by 2004 it controlled major subsidiaries in Liaoning, Jiangsu, Jilin, Anhui, Zhejiang, Sichuan and Wuhan and operated 37 breweries. Sales accounted for 12 percent of beer sales nationwide.<sup>44</sup>

During much of the early and mid-1990s, Beijing-based Yanjing, China’s second largest beer maker concentrated its efforts on maintaining its grip on the Beijing market and thus concentrated on buying rival breweries within the city. In 1999, however, it took over breweries in Hunan, Hubei, Jiangxi, and NeiMenggu. It also “invaded” Qingdao’s home provinces of Shandong. Between 2000 and 2004, Yanjing expanded into Guangxi,

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<sup>43</sup> *SCMP*, 12/29/99; *China Online (CO)*, 5/14/01, 5/14/01, 7/3/01, 7/21/01, and 4/9/02; *Zhongguo Shipping Nianjian 2003*; *AFX*, 9/30/04; *AP*, 6/16/04; *Global News Wire (GNW)*, 8/13/03; *Xinhua*, 9/1/04; and *The Standard*, 2/4/05.

<sup>44</sup> *SCMP*, 12/17/93, 11/9/94; 2/3/96, 8/21/96, 12/30/97, 6/1/99, 12/30/01, 5/14/01, 5/15/01, and 3/10/04; *CER*, 12/23/97; *Asia Pulse*, 4/24/98, 10/11/01, and 3/2/05; *Xinhua*, 12/14/00, and 2/19/02; *The Financial Times* 12/4/01; *The Standard* 8/16/03 and 6/30/03; *AFX* 5/31/01, 9/2/03, 3/9/04, 5/18/04, and 12/10/04; *Comtex* 9/17/04 and 5/21/04; China Resources Enterprise, Limited, *Annual Report 2004* available at [cre.com.hk/annual.asp?lang=e](http://cre.com.hk/annual.asp?lang=e).

Anhui, Zhejiang, and Guangdong, giving it a presence in most of eastern and central China and a 9-10 percent total market share.<sup>45</sup>

Other beer manufacturers also expanded into regional conglomerates. Guangdong Investments, for example, bought the Shenzhen Kingway Brewery in 1993 and then acquired control three breweries in Heilongjiang and Jilin, which it consolidated into the Northern Brewery Group in 1997. The following year it bought the Shandong Huazhong Brewery and built new breweries in Guangdong and Tianjin.<sup>46</sup> Chongqing Breweries, meanwhile, expanded by acquiring plants in Zhejiang and Hunan.<sup>47</sup> After being taken over by Anheuser-Busch, Harbin Beer not only bought out competing breweries in its home province of Heilongjiang, but also expanded into Liaoning and Hebei.<sup>48</sup>

In just under a decade, therefore, aggressive regional expansion by the major beer makers fundamentally changed the structure of China's beer sector. Even though the total number of beer makers remain high (over 500) by 2001-2 the "big four" (Qingdao, Huaran, Yanjing, and Harbin) accounted for 36% of total production. Seven regional producers accounted for an additional 14%. Thirty-one intermediate brewers a further 23%. The remaining 450 breweries produced just 17% of total output.<sup>49</sup> Not only did regional expansion result in the consolidation of the beer sector, it also created a much more tangled structure. Whereas most manufacturers limited their operations to a specific

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<sup>45</sup> *AFX*, 3/16/01, 11/21/00, and 7/28/03; *Global New Wire (GNW)*, 7/20/00, 7/16/02, 6/20/03, 10/11/03, 12/4/03, 10/29/04, 11/5/04, and 7/23/04; *Xinhua*, 1/12/96, 3/22/01, 2/25/04, and 12/13/04; *SCMP*, 7/25/00; *The Standard*, 9/25/04 and 7/23/04; *CO*, 3/9/01; and "Qiye licheng," available at yanjing.com.

<sup>46</sup> *SCMP*, 12/31/93, 6/13/97, and 6/23/98; *The Standard*, 7/23/03 and 12/2/04; and *GNW*, 5/31/04; Guangdong Investments was itself controlled by the Guangdong provincial government's Guangdong Yue Gang Investment Holdings. *The Standard*, 6/19/03.

<sup>47</sup> *GNW*, 8/24/04 and *Comtex*, 3/18/04.

<sup>48</sup> *SCMP*, 4/16/03, 8/30/02, and 8/20/01; *Nikkei Weekly*, 6/28/04; and *GNW*, 7/19/04.

<sup>49</sup> Based on data in *Zhongguo Shipin Nianjian 2003*.

locality or provinces during the 1980s, by the late 1990s the major producers had operations in multiple localities and provinces and only a few inland localities remained under de facto monopolies.<sup>50</sup> Moreover, having largely withdrawn from the Chinese market in the early 1990s, by the late 1990s many of the major international brewers had returned, often in the form of joint ventures with the major domestic producers. Thus, even though the beer market may have remained balkanized and in many cases the major brewers found it expedient to operate “locally” by retaining local brands, as the majors penetrated new localities they also forged new alliances with local governments and often sought to use these new ties to block other beer makers from entering the local market.<sup>51</sup>

Forging alliances with local governments and seeking local protection was not the only or even the major means by which beer makers sought to gain market share. Most often, the entry of new producers into a market would trigger a “price war” in which rival breweries would seek to uncut each other. Nationally, a glut of beer that began in 1996 also forced prices downward.<sup>52</sup> In the process, prices frequently fell below cost. In its attempt to wrest market share in Shanghai from the local giant Suntory, for instance, Qingdao dropped the price for its Huadong brand to ¥1.7 per bottle.<sup>53</sup> In other areas, local producers in some areas cut prices to a mere ¥1.9 in 1998 in hopes that low prices would deter the majors from seeking to make inroads in their localities.<sup>54</sup> In early 2005, a three-way fight for the Beijing market pitting Qingdao, Yanjing, and Huaran against each

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<sup>50</sup> *SCMP*, 10/25/98.

<sup>51</sup> *FT*, 6/23/01; *CO*, 2/25/02; and *SCMP*, 6/15/98 and 7/8/00.

<sup>52</sup> *Xinhua* 10/13/98.

<sup>53</sup> *The New Zealand Herald*, 11/21/00.

<sup>54</sup> *The Dominion (Wellington)*, 8/5/98.

other for the first time, drove prices in that city down to a scant ¥1.5 a bottle.

Competition in north China was reportedly so intense that one manager complained that price wars led companies first to “murder and then eventually suicide” as they sought to crush their rivals only to discover that in the process they have cut prices so low that their own corporations were financially devastated.<sup>55</sup>

Despite central government policies banning local protectionism, therefore, the domestic beer market clearly remained informally fragmented. Local protectionism did not, however, prevent China’s major breweries from seeking to expand national or regionally. Faced with informal trade restrictions and the threat that local governments would illicitly favor local beer manufacturers, the major breweries adopt strategies that allowed them to operate “locally.” In order to circumvent beer drinkers’ preference for local brands, they bought up existing breweries and retained established brand names. By buying existing plants, moreover, they were in a position to potentially assume their new subsidiary’s preexisting connections with local governments and hence potentially turn localism to their own advantage. To operate nationally or regionally, therefore, the major breweries adopted strategies that were premised on local protectionism. At the same time, though, they also used the classic market mechanism of price cutting to grab market share from rival producers, with the net result that even though the beer market remained fragmented by local protectionism, producers look to a combination of acquisitions, mergers, and price wars to expand their business in manner that differed little from the tactics used by beer manufacturers in more marketized economies.

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<sup>55</sup> *The FT*, 7/23/01. In 2004, prices had fallen so low that twenty-two major brewers reportedly sought to negotiate an agreement that would allow them to raise prices sufficiently to cover rising input and production costs. AP-Foodtechnology.com 4/15/04, available at ap-foodtechnology.com.

In many respects, the evolution of the automotive sector mirrors that of the beer sector. By the mid-1990s, China had 120 odd automobile manufacturers and vehicles were produced in 26 provinces.<sup>56</sup> Twenty-four provincial governments, moreover, had designated automotives as a “pillar” industry.<sup>57</sup> Substantial investment in upgrading and expanding production facilities led to rapid increases in productive capacity with the result that by 1999 installed capacity had reached 3 million units per year. Four years later capacity rose to 3.5 million and was predicted to reach 4.7 million in 2005. Demand, however, lagged behind capacity, with the result that utilization rates hovered around 50% in 1997. Excess inventories were also substantial, with upwards of 15% of vehicles remaining unsold each year in the later 1990s.

Despite the substantial overhang created by excess capacity, competition was slow to develop. Prior to the mid-1990s relatively few vehicles were sold to individuals and it was until the later 1990s that a substantial consumer market for vehicles began to emerge. Prior till then, most vehicles were bought by state or collective units. It was, therefore, relatively easy for local governments to ensure that locally produced vehicles were favored. As sales to consumers increased, local governments predictably slapped “imported” vehicles with a variety of ad-hoc fees that ensured that they were more expensive to buy and operated than locally made vehicles.<sup>58</sup> In some areas, including Beijing, Shanghai, Guangzhou, and local governments either banned imports or restricted their access to city streets.

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<sup>56</sup> The four provinces that did not produce automobiles were Xizang, Gansu, Qinghai, and Ningxia. *SCMP*, 3/27/97 and *Zhongguo Tongji Nianjian*, various years.

<sup>57</sup> Based on data in Fourin “China Auto Weekly,” 2/7/05 ([www.fourin.com](http://www.fourin.com)).

<sup>58</sup> *Kyodo*, 3/30/01.

The auto markets was not, however, carved up into a series of local fiefdoms dominated by a single local manufacturer. To begin with, the automotive sector was less fragmented than suggested by the raw figure of 120 vehicle manufacturers. As it developed in 1990s, the sector became more concentrated.<sup>59</sup> Whereas in 1991 the top 15 manufacturers accounted for 78% of total vehicle output, in 2001 they accounted for 91%.<sup>60</sup> Among passenger car makers, the Shanghai Automotive Industries Corp. (SAIC) and First Automotive Works (FAW) accounted for 74.12% of sales in 2000, 69.82% in 2001, and 64.80% in 2002 (see Table 1). The top five producers accounted for 96.47% of sales in 2000, 91.49% in 2001, and 86.36% in 2002.<sup>61</sup>

<b>Manufacturing Group</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
SAIC	41.28	41.00	38.11
FAW	32.84	28.82	26.69
Chang'an	8.61	7.18	10.20
Dongfeng	8.48	7.37	6.26
Guangzhou Honda	5.26	7.12	5.10
Geely			3.48
Zhengzhou Nissan			3.36
Nanya			2.08
BYD			1.43
CAIC			1.26
BAW	0.75	0.67	0.78
Huachen	2.50		0.77

**Source:** Auto in China: <http://www.cacauto.com/english.asp>.

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<sup>59</sup> *SCMP*, 8/07/00.

<sup>60</sup> China National Automotive Industry Consulting & Development Corp., “*Industrial Policy for Automotive Industry Promotes the Development of Automotive Industry*,” March 2002, available at <http://www.cacauto.com>.

<sup>61</sup> See Eric Thun, “Industrial Policy, Chinese-Style: FDI, Regulation, and Dreams of National Champions in the Auto Sector,” *Journal of East Asian Studies* 4, no. 3 (September-December 2004).

By 2003-4, eight enterprise groups dominated the automotive sector.<sup>62</sup> Combined, they controlled 48 out of 120 automakers. The big eight accounted for nearly 80% to all vehicles sold (see Table 2). Their subsidiaries dominated the production of passenger cars, producing approximately 90% of cars sold. Only seven independents produced passenger cars.<sup>63</sup> Most of these, however, sold around 20,000 cars while the largest (Chery which built nearly 87,000 cars in 2004) was a subsidiary of SAIC between 2001 and 2003.

<b>Group</b>	<b>Number of Subsidiaries</b>	<b>Vehicles Sales</b>	<b>Car Sales</b>	<b>Truck Sales</b>	<b>Bus Sales</b>
FAWs	11	20.18	27.12	18.45	10.97
SAIC	8	16.73	26.53	2.95	11.55
Chang'an	5	9.95	6.76	4.85	20.45
Dongfeng	5	9.93	9.13	15.32	3.88
BAW	3	9.76	5.93	21.43	2.95
CAIC	7	6.20	2.47	2.11	20.71
GAW	4	4.13	8.69	0.36	0.13
Geely	5	1.91	4.15		
<b>Total</b>	<b>48</b>	<b>78.79</b>	<b>91.77</b>	<b>65.46</b>	<b>70.64</b>

**Source:** FOURIN China Auto Weekly, "China Automotive Monthly Statistics," 2/7/05.

The big eight's grip on truck and bus sales was less absolute. Even so, the big eight's subsidiaries had a 65% share of the truck market and a 70% share of the bus market in 2004.<sup>64</sup> Unlike the passenger car sub-sector, the majors faced large number of independents in the truck and bus sub-sectors. Sixty-eight independents built trucks or

<sup>62</sup> A ninth enterprise group NORINCO (North China Industries Group) was a minor producer of trucks and buses. NORINCO is one of the major firms in the Chinese defense industry.

<sup>63</sup> Huachen (aka Brilliance), Hunan Jiangnan, Jilin Tongtian, Yuejin, Dongnan, BYD, and Chery.

<sup>64</sup> Small passenger buses, including the popular *mianbao* (bread loaf) minibus, accounted for 93% of bus production in 2004. See FOURIN China Auto Weekly, "China Automotive Monthly Statistics," 2/7/05.

buses in 2004. A few of the independents were relatively large. In 2004, for example, Anhui Jianghuai produced over 127,000 trucks and minibuses, Shenyang Jinbei over 77,000 minibuses, and Yuejin almost 70,000 trucks and buses. Most other independents were small with 45 out of 66 independents producing less than 10,000 vehicles annual, including eight that produced between 1,000 and 500, and 14 that produced less than 500.

The conglomerates that dominated the automotive sector were regionally diversified. China's largest car manufacturer SAIC, for instance, had most of its operations concentrated in Shanghai (Shanghai VW, Shanghai GM, and Shanghai Huizhong) and had built up local production of components in a conscious effort to localize its supply base.<sup>65</sup> In 1998, however, SAIC began expanding outside the city by forming a joint venture with General Motors in Guangxi (SAIC GM Wuling). The following year it set up a new venture (Shanghai Yizheng) in Jiangsu. In 2000, it bought a stake in Anhui-based Chery.<sup>66</sup> In 2004, SAIC and GM bought plants in Shandong (Yantai Dongyue) and Liaoning (Jinbei Automotive which became SAIC GM Beisheng).

FAW started out with a core of subsidiaries mostly located in and around Changchun, Jilin.<sup>67</sup> In the mid-1990s, however, it took over Harbin Light Duty Trucks

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<sup>65</sup> Huang, *Selling China*: 264-270.

<sup>66</sup> The SAIC-Chery deal ended badly. Chery began as an independent in 1999 building a version of the Spanish Seat Toledo using an assembly line bought from a Mexican company. In 2001, SAIC bought a 20% stake in the company but allowed Chery to continue to operate independently. In 2003, Chery introduced a new subcompact, the QQ, which GM and its Korean subsidiary Daewoo charged was a copy of the Daewoo Matiz/Chevrolet Spark which is produced in China by SAIC Wuling GM. Chinese regulators, however, rejected GM's claims in September 2004. Dissatisfied, SAIC dissolved its relationship with Chery and sold its shares. GM subsequently sued. *Shenzhen Daily* 10/8/04, *CD* 12/18/05, and *Xinhuanet*, 10/1/04.

<sup>67</sup> FAW's Jilin operations included FAW Jiefang (trucks), the FAW Automotive (producer of the Hongqi (Red Flag), FAW Volkswagen (JV producing the Jetta and Bora), the FAW Bus, FAW Special Purposed Automotive, FAW Fengyue Co. (JV producing Toyota Land Cruisers), the Jilin FAW Sanyou (trucks); and the Changchung FAW Light Duty Trucks.

and Hainan Auto Works, which produced Mazda sedans in Haikou; forming a joint venture with Mazda to produce sedans in Jilin; and absorbing Jilin Light Duty Vehicles. During 2001-2, FAW took over Tianjin Huali and Tianjin Xiali (one of China's major passenger car producers);<sup>68</sup> formed a new joint venture with Toyota (Tianjin FAW Toyota); and set up a new subsidiary in Chengdu which it then used to buy Sichuan Station Wagon and thereby gain control of Sichuan Toyota. In 2003, FAW formed a second venture with Mazda in Jilin.

Dongfeng, meanwhile, expanded its facilities in Wuhan in 1990 with a joint venture with Peugeot (Dongfeng Peugeot Citroen), while also buying Liuzhou Automotive (aka Chenglong) in Guangxi. In 1998, Dongfeng acquired Jiangsu-based Yueda-Kia. Two years later, it teamed up with a Taiwanese auto company, Yulon, to form the Aeolus Corp. (aka Fengshan) in Guangzhou. In 2001, it established a new subsidiary, Dongfeng Rongcheng, in Shandong. Two years later, Dongfeng entered into a joint venture with Honda to produce SUVs in Wuhan.

China's fourth major auto maker, Chang'an owned two major plants Chang'an Suzuki and Chang'an Ford in Chongqing and subsidiaries in Anhui (Anhui Tongbao), Jiangsu (Nanjing Chang'an), and Hebei (Hebei Chang'an Shengli). Though a relatively small producer, China Aircraft Industries Corp. (CAIC) had its operations spread across five provinces – Liaoning (Shenyang Aircraft Co.), Shaanxi (Shaanxi Hanjiang and Xi'an Volvo), Jiangxi (Changhe Suzuki), Heilongjiang (Harbin Hafai), and Guizhou (Guizhou

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<sup>68</sup> FAW took over at the behest of the Ministry of Machine Building Industries, after TAW was driven to the financial wall in a vicious price war with Geely. Although FAW was interested in the Xiali and Huali lines, it did not want to take on Xiali's bloated workforce. After FAW initially balked, the ministry agreed to let it lay off 45,000 TAW employees. *CO*, 4/2/01, 4/15/01, 6/17/01, and 6/18/01.

Aviation). Beijing Auto Works and Guangzhou Honda, on the other hand, remained concentrated in their respective home towns.

By 2004, regional diversification, combined with a spate of new entries, had created a complex sectoral geography with an admixture of the major conglomerates and independents in most provinces (see Table 3). Regional diversity is also apparent in the limited available data on retail sales which show that while particular manufacturers enjoyed a disproportionate market share in some cities, no manufacturer had exclusive or even dominant control over any of the markets for which sales data were available (see Table 4). Moreover, the data show strong sales by upstart makers such as Chery, which was largely owned by the Wuhu city government, and Geely, which was a private company.

Table 3

## Automobile Conglomerates and Manufacturing Firms (including subsidiaries), 2004

Province	Output	Conglomerates	Manufacturers
Beijing	531,090	BAW, NORINCO	<b>Beijing Automobile Works</b> , Beijing Beilu, Beiqi Futian, Rongcheng Huatai, <b>BAW Beijing Jeep</b> , <b>NORINCO Beijing North Huade Neoplan</b> , <b>BAW Beijing Hyundai</b>
Tianjin	228,569	FAW	<b>FAW Huali (Tianjin)</b> , <b>FAW Tianjin Xiali</b> , <b>Tianjin FAW Toyota</b> , Tianjin Meiya
Hebei	86,247	Chang'an, Great Wall	Baoding Dadi, Baoding Tianma, <b>Chang'an Shengli</b> , <b>Great Wall Motors</b> , <b>Hebei Chang'an Shengli</b> , Hebei Xinkai, Hebei Zhongxing, Qinhuangdao Jincheng, Shuanghuan Auto, <b>GW Zhongke Huabei</b>
Shanxi	319		Shanxi Auto
Nei Menggu	5,471	NORINCO	Shandanpai, <b>NORINCO North Benz</b>
Liaoning	150,444	Huachen, CAIC	Chengfeng Motors, Dandong Huanghai Auto, <b>Huachen BMW</b> , Liaoning Huanghai, Liaoning Lingyuan, Liaoning SG Auto, <b>CAIC Shenyang Aircraft</b> , Shenyang Fusang, <b>Huachen Shenyang Jinbei</b> , Shenyang Zhongshun, Songliao Auto, <b>SAIC GM Beisheng</b>
Jilin	669,107	FAW	Chang Chun Sammitr Motors, <b>FAW Jilin Light Duty Vehicles</b> , <b>First Automobile Works</b> , <b>FAW-Mazda</b> , <b>FAW-Volkswagen</b> , Jilin Tongtian
Heilongjiang	205,115	FAW, CAIC	<b>FAW Harbin Light-Duty Truck</b> , <b>CAIC Harbin Hafei</b>
Shanghai	620,343	SAIC, Geely	<b>Shanghai Automotive Industry Corp</b> , Shanghai GM, Geely Shanghai Huapu, SAIC Huizhong, <b>Geely Shanghai Maple Guorun</b> , Shanghai Volkswagen, Shanghai Wanfeng
Jiangsu	317,868	Dongfeng, Nanjing Yuejin, Chang'an, SAIC	Changzhou Changjiang, Changzhou Motors, Chunlan Auto, <b>Dongfeng Yueda Kia Motors</b> , Fareast Auto, <b>Nanjing Yuejin Jiangsu Nanya Fiat</b> , Mudan Automobile Co., <b>Nanjing Chang'an</b> , <b>Nanjing Yuejin Motors</b> , <b>Nanjing Yuejin NAVECO</b> , SAIC Yizheng, Sandi, SGM Beisheng, SAIC Yizheng, Taixing Machinery, Yangzhou Yaxing Motors, Yaxing Motors, <b>Nanjing Yuejin Light Duty Vehicles</b> , Zhangjiagang Jiangnan Auto
Zhejiang	87,193	Geely	<b>Geely Haoqing</b> , Jinhua Neoplan, Sanxing Aux, Zhejiang Gonow Auto, Zhengjiang
Anhui	131,059	Chang'an	Anhui Ankai, Anhui Feicai, Anhui Hualing, Anhui Huayang, Anhui Jianghuai, <b>Chang'an Tongbao</b> , Chery, China Yangzi
Fujian	83,871	Fujian Motor Industry Group	<b>Fujian Motors Dongnan</b> , Fujian Bamin, Fujian Longma, Fuzhou New Forta, Southeast Motors, <b>Fujian Motors Xiamen Golden Dragon</b> , Xiamen King Long United
Jiangxi	185,407	CAIC	<b>CAIC Changhe</b> , <b>CAIC Changhe Suzuki</b> , Jiangling Motors, Jiangxi Fuqi, Jiangxi Zhongxing Fuqi Auto
Shandong	116,421	Dongfeng, SAIC	Binzhou Gonow, China National Heavy Duty Trucks, Dongan Heibao, <b>Dongfeng Rongchang</b> , Etsong Auto, Rongcheng Huatai, <b>SAIC Volvo Sunwin</b> , SGM Dongyue, Shandong Kaima, Yantai Automobile, Zibo Auto
Henan	30,226		China Yituo/Luoyang First Auto, Zheng Yutong, Zhengzhou Nissan, Zhengzhou Qingxing

**Table 3**  
**Automobile Conglomerates and Manufacturing Firms (including subsidiaries), 2004**

<b>Province</b>	<b>Output</b>	<b>Conglomerates</b>	<b>Manufacturers</b>
Hubei	393,450	Dongfeng	<b>Dongfeng Honda, Dongfeng Motors, Dongfeng Peugeot Citroen</b> , Hanyang Tezhong, Hubei Sanhuan, Sanjiang Renault, <b>Dongfeng Zhongyu Automobile</b>
Hunan	9,730		Hunan Auto, Hunan Axle, Hunan Changfeng, Hunan Chenzhou, Hunan Sanxiang, Hunan Xingma, Jiangnan Auto
Guangdong	272,001	Dongfeng, GAC	<b>Dongfeng Aeolus</b> , Dongguan CNAIC, <b>Dongfeng Fengshan Automotive, GAC Guangdong Automobile, GAC Guangdong Isuzu</b> , Guangzhou Baolong, <b>GAC Guangzhou Honda</b> , Guangzhou Longbao, <b>GAC Guangzhou Yangcheng</b> , Nanhai Fudai, Qingyuan Yuejiang, Zhanjiang Shanxing
Guangxi	235,727	Dongfeng, SAIC	<b>Dongfeng Liuzhou</b> , Guilin Daewoo, <b>SAIC GM Wuling</b>
Hainan	66,055	FAW	<b>FAW Hainan</b>
Chongqing	489,238	Chang'an, NORINCO	<b>Chang'an Auto, Chang'an Ford, Chang'an Suzuki</b> , Chongqing Truck, <b>NORINCO Chongqing Isuzu</b> , Chongqing Jingguan, Chongqing Lifan, Chongqing Special, Qingling Motors, Yuzhou Motor
Sichuan	42,338	Chang'an, FAW	Changzheng Auto, Chengdu Loncin, Chengdu Wangpai, Chengdu Xindadi, Chang'an Suzuki, FAW Chengdu, Qingling Motors, Sichuan Auto, Sichuan Chuanlu Auto, FAW Sichuan Toyota, Sichuan Yinhe
Guizhou	184	CAIC	<b>CAIC Guizhou</b> , Guizhou Yunque
Yunnan	45,734	FAW	<b>FAW Hongta Yunnan</b> , Yunnan Jinma
Shaanxi	51,199	CAIC	BYD, <b>CAIC Shaanxi Aircraft</b> , Shaanxi Auto, Shaanxi Hanjiang, <b>CAIC Xi'an Volvo</b>
Xinjiang	5	FAW	<b>FAW Xinjiang</b>

**Notes:** Column “Conglomerates” blank where only independents operating in province.  
 Subsidiaries of conglomerates in bold.

**Source:** Based on data in FOURIN China Auto Weekly, “China Automotive Monthly Statistics,” 2/7/05 and Autoindex, “World Car Catalogue,” <http://www.autoindex.org/>.

<b>Table 4</b>								
<b>Automotive Market Share</b>								
<b>Corporation</b>	<b>National</b>	<b>Chengdu</b>	<b>Yantai</b>	<b>Xi'an</b>	<b>Shenyang</b>	<b>Yunnan</b>	<b>Shanghai</b>	<b>Beijing</b>
<b>2003</b>								
BAW	7.67			7.48	10.11			1.41
BYD	0.46	8.12		0.29		0.57		3.09
Chang'an	9.36	22.51	0.28	16.85		7.28	1.92	4.54
Chery		3.48	0.85			10.12	5.78	6.65
CAIC	7.40	11.38		15.74	3.70	2.47		5.91
Dongfeng	10.74	5.66	4.29	0.65	3.98	8.89	7.47	21.01
FAW	20.59	7.48	8.86	1.01	18.00	15.86	4.51	35.22
Geely	1.72	2.18	0.24					5.12
GAC	2.79		2.12			1.18		0.07
SAIC	17.81	3.73	15.32	2.18		15.85	45.27	9.28
<b>2004</b>								
BAW	10.47	0.51	0.50	4.49	4.33	1.84		2.82
BYD	0.35	4.65	0.19	1.05		3.39		0.64
Chang'an	9.95	21.30	2.49	2.13	0.64	13.50	5.99	7.79
Chery	1.71	6.02	0.08			7.27	4.85	5.18
CAIC	6.20	6.96		10.32	8.13	6.66		6.05
Dongfeng	9.93	7.65	2.09	1.77	0.96	1.65	9.54	19.05
FAW	19.87	5.91	12.27	6.31	18.89		3.76	41.23
Geely	1.91	3.49		0.21				3.15
GAC	4.13		1.75			5.22	0.82	0.79
SAIC	16.73	2.53	7.93	7.16		14.78	32.02	7.95

**Source:** Beiya Automarket Web Site: <http://www.beiyacheshi.com/> and FOURIN China Auto Weekly, "China Automotive Monthly Statistics," 2/7/05 and Autoindex, "World Car Catalogue," <http://www.autoindex.org/>

As in the beer sector, regional diversification blurred the political geography of the automotive sector. During the 1980s, connections between automakers and particular governments were reasonably clear. FAW, Dongfeng, and China National Heavy-duty Truck Corp (CNHDTC) came under the direct control of the State Planning Commission, making them “central” units. SAIC, TAW, BAW, and Guangzhou Auto Works were owned by their respective municipal governments. NORINCO and CAIC were part of the defense industry and hence belonged to the Ministry of Defense.<sup>69</sup> By 2004, most of the major firms had been transformed into joint stock companies (Dongfeng, FAW, SAIC, Huachen, CNHTC, and Chang’an were publicly listed) and the state’s ownership rights had been transferred to state asset management committees or state holding companies.<sup>70</sup> Most were involved in joint ventures with foreign partners. The connection between state agencies and enterprises that putatively lies at the heart of local protectionism, the link that ties the financial interests of the local governments to the profits of local firms, was thus attenuated. Moreover, because most automakers were now operating in multiple provinces, they had incentives to form alliances with multiple governments. The presence of multiple automakers in the same locality, on the other hand, meant that local governments faced cross pressures from rival local producers. As a result, the correspondence between “local” enterprise and their local government counterparts became blurred and convoluted.

Unable to wall off segments of the market and faced with excess supply, automakers soon found themselves locked into a bitter price war. During the early 1990s,

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<sup>69</sup> Wayne W.J. Xing, “Shifting Gears,” *The China Business Review*, November-December 1997.

<sup>70</sup> Shanghai Stock Exchange website (sse.com.cn); Shenzhen Stock Exchange website (szse.com.cn); and the Hong Kong Stock Exchange website (hkex.com.hk).

high tariffs (upwards of 100%) and the lack of a retail market (most vehicles were purchased by units rather than private individuals) allowed domestic manufacturers to keep prices high.<sup>71</sup> High profit margins, naturally, induced excessive production and by the mid-1990s car makers found themselves facing increasing inventories and hence pressures to cut prices. After some preliminary price cutting in 1994, the price war began in earnest in 1996 when Shanghai VW cut the price of its Santana by almost 20%. Others followed suit. At the same time, the introduction of relatively cheap compacts such as the Tianjin Xiali, Chang'an Alto, and the Guizhou Yunque created a new threat to higher priced sedans.<sup>72</sup> The war intensified in 1998 when the government relaxed price controls and replaced state regulated prices with price guidelines but failed to enact effective enforcement mechanisms. Facing only superficial penalties, manufacturers were quick to cut prices, which the central government then rubber stamped.<sup>73</sup>

Absent systematic price data, it is difficult to rigorously document the extent of price cutting. Nevertheless, it is clear that competition drove prices down sharply. During 2000, for instance, Shanghai GM cut prices 6%, Dongfeng 5-9%, Shanghai VW 10-13%, Tianjin Xiali 12%, and Nanjing Yuejin 16%.<sup>74</sup> The trend in 2001 was the same with prices for many popular models falling 10-20% (see Table 5). Thereafter, price cutting continued as Shanghai VW cut the Santana's price 7%, Shanghai GM lowered the Sail's price 7%, and Tianjin Xiali cut the Charade's price 13% and that of the Vela 18% during

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<sup>71</sup> *Xinhua*, 10/7/94 and 2/26/92.

<sup>72</sup> *Xinhua*, 1/31/97; 3/10/97; 6/18/97; 6/22/97; and 12/10/97.

<sup>73</sup> In 2001 the central government threw in the towel and granted automakers the right to set prices.. *CO*, 9/15/98 and 5/22/01.

<sup>74</sup> *CO*, 4/7/00; 7/28/00; 7/24/00; 7/21/00; 7/18/00; 8/31/00; 8/29/00; and 12/13/00.

2002.<sup>75</sup> Prices for the top-25 selling vehicles in Beijing dropped an average of 7.6% in 2003 and 8.7% in 2004. Of the 45 models sold in both 2002 and 2003, prices for 31 (69%) averaged 9% less in 2003. The following year, prices for 48 out of 58 models (83%) sold in both years fell an average of 14%.<sup>76</sup> Among the 22 models for sale in all three years, prices for 21 fell an average of 22% and the average price for ten best selling cars fell 30% from ¥120,000 to ¥84,000.<sup>77</sup> China's entry into the World Trade Organization (WTO) in 2002 put additional pressure on car prices by progressively cut custom's duties on imported cars from 70-80% in 2001 to 25-28% July 2006.<sup>78</sup> In addition to cutting prices, manufacturers upgraded existing models and introduced new models, thus offering buyers more value for their money.

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<sup>75</sup> Lee and Fujimoto, "The Chinese Automobile Industry."

<sup>76</sup> Based on sales data from the Beijing Yayuncun Auto Sales Center available at <http://www.cheshi.com.cn>.

<sup>77</sup> Experts predicted that price cutting would continue in 2005, with one predicting that prices for cars priced below ¥100,000 could fall as much as 50% and those for more expensive cars 20%. *CO*, 12/6/04.

<sup>78</sup> Wayne W.J. Xing, "Automakers in the Fast Lane," *China Business Review* July-August 2002, p. 12.

<b>Manufacturer</b>	<b>Model</b>	<b>Original price</b>	<b>New price</b>	<b>Amount cut</b>	<b>Percent</b>
Geely	Haoqing	44,900	39,900	5,000	11.1
TAW	Xiali TJ7101	48,900	39,800	9,100	18.6
Geely	Merrie	59,900	55,500	4,400	7.3
Chang'an	Lingyang	112,700	98,800	13,900	12.3
FAW-VW	Jetta CI	117,000	99,800	17,200	14.7
TAW	Xiali 2000	119,980	97,000	23,000	19.2
Shanghai GM	Sail	125,000	115,000	10,000	8.0
FAW-Hainan	Hainan Mazda	126,000	116,000	10,000	7.9
Dongfeng-Citroën	Fukang	141,000	133,000	8,000	5.7
FAW	Red Flag	240,000	218,000	22,000	9.1
Shanghai VW	Passat B5	245,000	225,000	20,000	8.1
Guangzhou Honda	Honda Civic	300,000	270,000	30,000	10.0
Dongfeng Aeolus	Nissan Sentra	310,000	260,000	50,000	16.1
Tianjin FAW Toyota	Toyota Camry	390,000	350,000	40,000	10.2
Average					11.3

**Source:** *China Online*, 1/22/02.

In sum we confront evidence of both local protectionism and stiff market-driven competition in the automotive sector. Faced with excess production in the mid-1990s, automakers responded by cutting prices and seeking new customers, including private buyers for the first time. Price cutting and product upgrading increased as new domestic producers entered the sector and existing producers set up new production facilities. Corporations undoubtedly sought the assistance of local governments in controlling access to markets. In some cases, government intervention was quite substantial, as is evident in the case of SAIC where the Shanghai municipal government clearly manipulated local regulations to give SAIC a significant edge. The extent of local protectionism, however, appears secondary to a more generalized resort to the classic market tactic of lower prices in hope of undercutting the competition and gaining market share. This is not necessarily surprising because whereas local protectionism might

cordon off a firm's home market and hence provide protection for small and mid-size producers, it could not help larger firms expand into new markets unless, of course, these firms were able to forge alliances with other local governments. Spatial expansion thus allowed producers to "jump" over potential barriers. As in the beer sector, regional diversification created complex networks of interests connecting the major producers to a wide range of local governments, while at the same time confronting local governments with rival claims for "assistance." The evidence thus suggests that although local protectionism continues to exist within the automotive sector, it exists in an increasingly marketized context wherein automakers must rely more heavily on market tactics as they fight to expand market share.

### **Analysis**

As evidenced by the contrast between the widespread resort to trade protectionism as a hedge against competition during the 1989-90 recession and the resort to discounted and prices wars during the 1997-9 deflation, by the late 1990s the Chinese economy had moved a considerable way from the plan and toward the market. The evidence of continued local protectionism in the beer and automotive sectors, however, also clearly shows that it remained a "market with Chinese characteristics." That is, an economy that combined contradictory features. In these sectors, the economy was characterized by informal trade barriers that split the national market into a series of localized markets and fierce competition among rival producers within these market segments. Even where one producer enjoyed "hegemony," competitive pressures and a quest for enhanced market share had clearly created rivalries between a series of major conglomerates then drove them to seek to expand their scope of operations by penetrating markets dominated by

other producers. Because local governments continued to interfere in local markets and to support local firms, the most effective means of breaking into new markets lay in a strategy of “operating locally” by purchasing local firms and converting them to subsidiaries (in the case of the beer sector) or by setting up new joint ventures with local firms and governments (in the case of the automotive sector). By operating locally, the emerging national conglomerates were able either neutralize local governments propensity to favor local firms over outside vendors or to forge informal alliances that turned their protectionism impulses to the advantage of the new entrant.

What drove this transition from the plan toward the market? The trite answer is that it was a complicated process driven in part by top-down policy reforms and spontaneous bottom-up responses to these policy changes. I say the answer is trite because ultimately it seems obvious that any major change will involve interplay between that which policy makers intend and that which ultimately emerges out of an attempt at significant reform. Recognizing that centrality of the interaction between top-down policy change and bottom up response, however, brings to the fore the chaotic and evolutionary character of reform in China. It also highlights to extent to which outcomes have rarely approximate what reformers envisioned when they implemented reforms.

The disconnect between the reformers’ intentions and the trajectory of the reform process can be laid clear by tracing the evolution of industrial reforms from the mid-1980s through to the early 2000s. In the mid-1980s, the central government implemented three important reforms. First, it decentralized decision making authority, granting local governments greater leeway in implementing of economic policy, including greater control over investment decisions. Second, the center adopted a “dual price” system

wherein commodities would continue to be priced at a low, administratively fixed price for sale to “in-plan” consumers but would be priced at a higher “market” price for “out-of-plan” consumers. Third, it granted greater authority to enterprise managers, include responsibility for profits and the right to retain a share of profits and use those retained profits for both reinvestment and welfare benefits for enterprise employees (including the managers).

In theory, all four policy changes were aimed at stimulating industrial growth by encouraging local governments and enterprise managers to increase productive efficiency and channel investment into new profitable activities. At the same time, however, the center also eliminated the old unitary budget system and replaced it with a new multi-level system in which local governments gained greater discretion over spending but also – and perhaps more critically – greater responsibility for generating local revenues. While the first three policy changes might have stimulated profit seeking, the latter encouraged rent seeking. Quite simply, given a gap between in plan and market prices, enterprises and local governments – as well as individuals – could obtain handsome returns from simple arbitrage, buying at the lower in-plan price and reselling at the higher market price. Because many of the price gaps created by the “dual track price system” were in the agricultural sector, the result was a series of “resource wars” wherein localities and private traders “fought” for control over undervalued commodities such as tobacco, wool, cotton, silk cocoons, etc. Commodities such as coal were also subject to rampant black marketing and “official profiteering” (*guandao*).

The combination of reforms also triggered a less obvious form of rent seeking. Because the government had systematically underinvested in consumer goods production

during the Maoist period, reforms in these sectors were initiated under conditions of systematic shortages. Because prices remained subject to state controls, this meant that gaps existed between the state fixed price and the “shadow price” that consumers would be willing to pay for scarce goods. Moreover, prices for many consumer goods had been fixed at high levels relative to production costs, with the result that not only did market prices diverge from fixed prices, but profit margins were high in a wide range of light industrial sectors. Because many of these sector also required relatively low capital investment, when the center decentralized authority to local governments and enterprise managers, new investment flowed toward these sectors, triggering both an expansion in productive capacity among existing producers but also the entry of new producers, with all seeking to cash in on existing high profit margins and the well of unmet consumer demand.

Such was the case in the beer industry where the early days of reform saw a major proliferation in the number of breweries. Despite its greater capital intensity, the automotive sector also saw an increase in the number of producers, as well as expansion by existing producers. So long as pervasive shortages existed, neither an influx of new entrants nor the expansion of existing producers necessarily created antagonistic contradictions between producers— and in most cases their local government owners — expect in localities where new entrants sought to horn in on markets previously dominated by an established producers. Even in such areas, so long as there remained unmet consumer demand, new and existing producers could, in theory, coexist.

Once shortage gave way to glut, the interests of rival producers necessarily became antagonistic contradictions. As the 1988 Retrenchment tightened consumer

demand, mounting commercial contradictions among producers led some to seek relief from their local government owners. As local governments began to raise trade barriers and restrict access to local markets in hopes of bolstering sales of local goods, others retaliating, creating an escalatory spiral of trade protectionism that left the Chinese economy badly fragmented during the winter of 1989-90.

Although the central government responded to escalating local protectionism by issuing new decrees mandating the elimination of all local trade restrictions, the shift from austerity to boom that followed Deng Xiaoping's Southern Tour did more to lower internal trade barriers. With consumer demand once again pushing out beyond supply, the mid-1990s saw a second round of expanding productive capacity. Eventually, expansion in capacity once again pushed supply beyond demand, softening markets and creating deflationary pressures. Deflation confronted producers with the same problem they had faced during the 1989-90 recession: how to dispose of excess inventory. While we have some evidence that they sought the same sort of administrative relief they had previously and that some local government did raise inter-regional trade barriers, the evidence much more clearly establishes that most producers turned to discounting, seeking to undercut their competitors in hopes of either hanging on to existing market share or actually gaining market share at the expense of their weaker competitors.

The shift away from local protectionism and toward price fighting was largely the result of two sets of reform policies implemented in the late 1980s and early 1990s. The first set of reforms involved the conversion of state-owned enterprise into legal corporations. Although nominally owned by the public at large, state-owned enterprises were in fact "privately" held corporations in which a single state organization held

proprietary rights to the enterprises income. In a sense, a state owned enterprise was a “productive bureau” directed and controlled by an “administrative bureau.” Managers had limited autonomy and were more bureaucrat than businessman. In the mid-1980s, the central government issued new policies providing the managers of SOEs with greater autonomy and ordering local governments to stop interfering with day-to-day operations. In 1987, it ordered SOEs converted into “corporations” which meant that they would acquire the status of a “legal person.” The following year, the new SOE Law directed government agencies to transfer their ownership rights to asset management committees who would exercise ownership and oversight authority on behalf of “the state” and would receive profits due the state. Five years later, the central government issues new regulations allowing SOEs to become “limited liability corporations” or “joint stock corporations.”

The second set of reforms involved two changes to the fiscal system. First, in 1993 the central government modified the rules on extra-budgetary funds.<sup>79</sup> Therefore, SOE profits were treated as a form of extra-budgetary funds. Under the new rules, only those funds belonging to administrative agencies remained part of the “second” budget while those belong to state-owned enterprises were re-designated “profits.” This change technically restricted the ability of local governments to expropriate SOE funds, thus denying them easy access to what many localities had treated as what amounted to an

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<sup>79</sup> Extra-budgetary funds were revenues earned by public agencies in accordance with regulations that remain the property of the collecting agency and therefore not subject to reallocation via the regular “unitary budget.” Extra-budgetary funds do not include illicit revenues.

irregular tax on SOE income.<sup>80</sup> Second, in 1994 a major revision of the budgetary system expanded the use of the value added tax (VAT) and transferred collection authority to a newly created Central Tax Bureau, thus placing a new institutional intermediary between local governments and local enterprises.<sup>81</sup> More generally, the 1994 reforms formalized a shift away from enterprise income taxes to more broadly based turnover taxes that had seen the importance of enterprise income taxes decline from a third of total revenues in 1985 to around 15% by 1994-5 and then less than 10% by 1998.<sup>82</sup>

The combination of corporatization and reforms to the extra-budgetary and budgetary systems attenuated the ties between local governments and locally based enterprises. With their ownership rights transferred to what amounted to state-owned holding companies, local governments lost the right to directly control enterprises managers and enterprise revenues. Those rights were now exercised by corporate boards composed of directors nominated by the asset management committee. In many cases, however, directors were in fact either selected by enterprises managers or were quickly coopted by them, with the net result that control tended to slip away from the “owners” (i.e., the state) and into the hands of management. By placing additional barriers between local governments and the income of locally based enterprises, tax reform further insulated managers. In critical respects, therefore, when the economy roared into high

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<sup>80</sup> See Le-Yin Zhang, “Chinese Central-Provincial Fiscal Relationships, Budgetary Decline and the Impact of the 1994 Fiscal Reform: An Evaluation,” *China Quarterly* 157 (March 1999): 115-41.

<sup>81</sup> See Shougang Wang, “China’s 1994 Fiscal Reform: An Initial Assessment,” *Asian Survey* 37, no. 9 (September 1997): 801-17; Tsang Shu-ki and Cheng Yuk-shing, “China’s Tax Reform: Breakthrough or Compromise?” *Asian Survey* 34, no. 9 (September 1994): 769-88; Pak K. Lee, “Into the Trap of Strengthening State Capacity: China’s Tax-Assignment Reform,” *The China Quarterly* 164 (December 2000): 1007-24; and Athar Hussian and Juzhong Zhuang, “Enterprise Taxation and Transition to a Market Economy,” in Donald J.S. Brean, ed., *Taxation in Modern China* (New York: Routledge, 1998): 43-68.

<sup>82</sup> Based on data in *Zhongguo Tongji Nianjian*, various years.

gear following Deng's Southern Tour much of the old state-owned industrial sector was in fact still state-owned, but many enterprises were actually controlled of their managers. Moreover, the conversion of SOEs into joint stock corporations opened the way for one SOE to buy a stake or even a controlling interest in another. Conversely, of course, this also gave local governments a greater ability to sell off local enterprises.

The upshot of these changes was that during the boom years of the mid-1990s, enterprises looking to expand market share used mergers and acquisitions to circumvent irregular local trade barriers and jump into promising new markets. In the process, the "neat" division between "local" and "outside" enterprises often became blurred as heretofore "local" producers became local subsidiaries of "outside" enterprises or "outsiders" set up new "local" operations. Moreover, in many cases whereas there may have been a single major local producer in the late 1980s, by the mid-1990s it was not uncommon to have several major local producers. When excessive expansion of productive capacity saturated markets after 1997 it was thus much more difficult to forge coherent alliances to defend "local interests." For many enterprises it was likely much more expedient to turn to price cutting. Price cutting, after all, allowed them to not only fight both outsiders and – perhaps more importantly – other locals for market share locally, it also allowed them to fight for market share in other localities. Local protectionism, by contrast, could at best wall off one segment of the market. By the late 1990s, in sum, a fundamentally market logic offered a viable alternative to the resort to crude administrative intervention that had been the primary alternative in the late 1980s.

## Conclusion

As argued herein, reform was hardly a linear process guided by top down policy changes but rather a complex and often chaotic process. But the process was not a “random walk.” On the contrary, as anticipated by evolutionary economics there was an inner logic to the process, one which has its roots in the law of supply and demand but which was very much governed by institutional rigidities.

From a theoretical perspective, by dis-equilibrating the old command system, partial reform created a set of incongruent incentive structures and hence spawned reactions that were dysfunctional relative to the maintenance of the system envisioned. In particular, by granting local governments greater autonomy and forcing them become more fiscally self-reliant while at the same time create price system that create a series of rents, the first round of reforms not only led to substantial increases in investment and production, which the reformers desired, but also high levels of rents seeking, a response which was itself critically important to spurring increased production (see Figure 4). Increased production and rent seeking, in turn, eliminated many of the chronic shortages created by the misallocation of investment in the Maoist period but they ultimately led to glut. Glut then beget local protectionism. Local protectionism was, however, only a short-term solution to the problem of excess production and ultimately producers, many of who had been transformed into profit-driven corporations in the interim, had to turn to alternative means to defend and expand market share. Acting much like corporations in advanced market economies, this led firms to begin aggressively discounting their products, forcing others to follow suit. The resulting prices wars, finally, dissipated whatever price distortions remained in place.



The process was not, however, a neat linear progression governed by the laws of neo-classical economics. On the contrary, the informal ties that bound local producers to local governments were never eliminated, either by repeated central diktats ordering an end to local protectionism or by corporations' attempts to use discounting to break into new markets. As a result, corporations were forced to "localize" themselves by acquiring subsidiaries within particular market segments and forging new alliances with local governments. The net result was a segmented market economy in the sense that local protectionism continued to hamper interregional trade but within most market segments fierce competition had become a norm.

In this process, both top-down policy change and bottom-up "spontaneous reform" were necessary, but neither was sufficient. It was instead the dynamic interaction between top-down reform and bottom-up response that drove the process but in a distinctly non-dialectic manner. The effects of a number of critical policy changes, in fact, did not manifest themselves immediately and in some cases reforms appeared to produce little substantial change when they were enacted. In case in point, the conversion of SOEs into corporations seemed to have little consequence initially. The decision to retain state ownership of a substantial – but shrinking due to the more rapid growth of the non-state sector – part of the economy is often considered to be one of the major shortcomings of China's reforms. And yet it was the fact that **some** SOEs did transform themselves into market-oriented companies and began to look to mergers, acquisitions, and discounting as fundamental business strategies was likely the single most important factor in pushing the economy closer to a market-driven system when boom gave way to glut in the latter 1990s. Once these corporations penetrated existing market segments and began cutting

prices, other firms either had to capitulate or follow suit – that is, they had to transform themselves into market oriented corporations or die. But not all firms had to transform in order to survive because the politics of industrial transformation and the fact that to become competitive many SOEs had to restructure their operations and shed redundant workers and shutdown inefficient operations were such that some local governments – and the central government to a not inconsiderable extent as well – were willing to protect “their” client enterprises by providing subsidies. Market forces alone thus could not weed out all of the stunted “dinosaurs.”

In conclusion, the process of reform has been anything but a linear, neat, or even necessarily logical process. On the contrary, the attempt to reform China’s Marxist economy by incremental adjustment has given rise to a myriad of dysfunctional responses, including rent-seeking, corruption and abuse of power. But these “pathologies” are not necessarily “dead ends.” On the contrary, in key respects these dysfunctional behaviors drove the reform process well beyond the cautious steps envisioned by China’s conservative reformers. By thus pushing the reform process “off the stones” and into a more swiftly flowing current of reform, they not only made it almost impossible to turn the process around or halt it half way across the “river, they actually helped carry the reform process much closer to the “other bank.”