THE PEOPLE'S REPUBLIC OF CHINA, 1949-2012: A POLITICAL ECONOMY PERSPECTIVE

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DEDICATION

This is dedicated to my parents, my grandparents, and my brother for their support and encouragement over the years.
I wish to express the deepest gratitude to Dr. Charles K. Rowley, my dissertation director, for his intellectual guidance at every stage of my writing and for his helpful, detailed commentary on this dissertation. His wisdom, knowledge and commitment to the highest standards inspired and motivated me. I would like to thank my committee members, Dr. Walter E. Williams and Dr. John N. Paden, for their valuable suggestions during the planning stage of this research work, and their genuine help over the years.

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**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>List of Tables</th>
<th>viii</th>
</tr>
</thead>
<tbody>
<tr>
<td>List of Figures</td>
<td>x</td>
</tr>
<tr>
<td>Abstract</td>
<td>xi</td>
</tr>
</tbody>
</table>

Chapter 1: Setting the Scene – An Analytical History of Imperial China and the First Republic

1. Introduction ................................................................. 1
2. Imperial China: From Xia Dynasty to the Qing Dynasty (2070 BC – 1912 AD) ... 3
3. The Early Chinese Republic (1912 – 1949) ................................ 15

Chapter 2: Mao Zedong versus Deng Xiaoping – A Public Choice Evaluation of Two Key Dictators Who Shaped Modern China

1. Introduction ................................................................. 21
2. The Dictator’s Dilemma and Autocratic Equilibrium ...................... 22
3. Limitations of the Wintrobe Categorization ................................ 31
4. Mao Zedong – Political Ideology Formation ................................ 34
5. Mao Zedong – Transformation from a Totalitarian to a Tyrant Dictator .... 41
6. Conclusion ........................................................................... 49
7. Deng Xiaoping – Identifying His Ideological Puzzle ....................... 49
8. Deng’s Succession and Subsequent Behavior .................................. 55
9. Conclusion ........................................................................... 62

Chapter 3: A Political-Economic Timeline, 1949 – 2012

1. Introduction ........................................................................... 63
6. Xi Jinping: Princeling Totalitarian and Unknown Quality ................. 93
7. Conclusion .................................................................................................................. 97

1. Introduction .................................................................................................................. 99
2. Defining the Concept of Economic Freedom ............................................................. 100
3. Tiananmen Square Protests – 1989 ......................................................................... 104
   3.1. Background of the Tiananmen Square Protests .................................................. 104
   3.2. Economic Analysis of the Tiananmen Square Protests ...................................... 107
   4.1. Introduction ......................................................................................................... 118
   4.2. History of State-Owned Enterprises .................................................................. 119
   4.3. Reforms of State-Owned Enterprises: Power-Delegating and Profit-Sharing .... 122
   4.4. Economic Analysis of Power-Delegating and Profit-Sharing ............................. 124
   4.5. Reforms of State-Owned Enterprises: Corporatization .................................... 131
   4.6. Economic Analysis of Corporatization ............................................................... 133
   4.7. Conclusion .......................................................................................................... 144

1. Introduction .................................................................................................................. 145
2. China’s Accession to the WTO: 2001 ...................................................................... 146
4. Regulations and Policy Incentives on FDI since 1978 ............................................ 167
5. The Impact of Local Government Intervention on Foreign Capital ...................... 175
6. The Impact of FDI on the Growth of Non-State-Owned Enterprises ................. 185
7. The Impact of Economic Growth and Open-Door Policy on Labor Mobility ......... 196
8. Conclusion .................................................................................................................. 206

Chapter 6: China at a Political-Economic Crossroad – The October 2012 Congress and the Uncertain Prospect for Political and Economic Freedom .................................................. 215
1. Introduction .................................................................................................................. 215
2. A Model of Dictatorship ............................................................................................ 216
3. The Political System and Structure of China ............................................................ 222
5. Xi Jinping’s Rise and Bo Xilai’s Dismissal During the 2012 Politburo Transition:
   Two Scenarios Assessing the Future of Political and Economic Freedom in China... 241
LIST OF TABLES

Table 1 Total Investment in Fixed Assets (Billion Yuan) ........................................ 108
Table 2 Number of Protestors in 1989 by City/Province & Total Investment in Fixed
Assets in 1988 by Sector .............................................................................................. 110
Table 3 Number of Protestors in 1989 by City/Province & FDI and Other Investment
1988 by Region ............................................................................................................. 112
Table 4 Students Studying Abroad & Return Students ................................................................ 114
Table 5 Number of Protestors in 1989 by City/Province & Student Enrollment in Higher
Education in 1988 by Region ....................................................................................... 116
Table 6 Gross Industrial Output Value by Ownership (In Billion Yuan) ........................ 125
Table 7 Gross Industrial Output Value by Ownership as Percentage To Total Gross
Industrial Output Value ................................................................................................. 126
Table 8 Total Industrial Loss by Loss-making Industrial Enterprises (In Billion Yuan) .......................... 127
Table 9 Gross Industrial Output Value by Ownership (In Billion Yuan) and Percentage
Share .............................................................................................................................. 134
Table 10 Number of Industrial Enterprises by Ownership (Unit: 10,000) and Percentage
Share .............................................................................................................................. 135
Table 11 Loss and Net Profit of State-owned Industrial Enterprises .................................. 136
Table 12 Share of Loss-making and Profit-making Industrial Enterprises in Percentage
........................................................................................................................................ 137
Table 13 Loss and Net Profit of Collective-owned and Non-state Industrial Enterprises
........................................................................................................................................ 139
Table 14 Number of Industrial Enterprises by Ownership (Unit: 10,000) ......................... 141
Table 15 Number of Industrial Staff and Workers (10,000 person) ....................................... 142
Table 16 Tariff Reductions in China (1982-2001) ................................................................ 150
Table 17 Non-Tariff Barriers Reductions in China (1992-2001) ........................................ 152
Table 18 RMB Exchange Rate and Trade Balances (1985-2001) ..................................... 154
Table 19 External Borrowing .......................................................................................... 159
Table 20 Economic and Investment Indicators of SEZs in 1989 (In Millions of U.S.
Dollars) ......................................................................................................................... 162
Table 21 Actual FDI by Types of Enterprises, 1979-2000 (Unit: 100 million US Dollars
and Percentage) ........................................................................................................... 166
Table 22 Tax Incentives in SEZs ..................................................................................... 166
Table 23 Tax Incentives in Opened Cities and Economic and Technical Development
Zones ................................................................................................................................. 171
Table 24 Government Size at Provincial Level (2000-2009) ........................................... 181
Table 25 Average Government Size and Average Foreign Capital (2000-2009)........... 183
Table 26 Total Investment in Fixed Assets 1993-2000 (Unit: 100 million yuan)......... 187
Table 27 Gross Industrial Output Value of All State-owned and Non-state-owned
Enterprises in China 2000-2009 (Unit: 100 million yuan) .................................... 189
Table 28 Foreign Capital Actually Used in China 2000-2009 (Unit: 10,000 USD)....... 192
Table 29 Average Foreign Capital Actually Used and Ratio between Non-state-owned
and State-owned Enterprises of Average Value-added of Industry in China .............. 194
Table 30 Major Aggregate Migrant Figures, 1982-2009 (in millions) ...................... 204
Table 31 The 17th Politburo Standing Committee of the Communist Party of China .... 224
Table 32 Chain-linked & Unjusted Ratings and Rankings (1980-2010) ..................... 254
Table 33 Ten Economic Freedom Indexes in China 2012 ...................................... 260
Table 34 China’s Key Conditions of Political Rights and Civil Liberties in 2012 ...... 266
Table 35 China’s Key Conditions of Freedom of the Press in 2011 ........................ 272
Table 36 China’s Key Conditions of Freedom of the Internet and Digital Media in 2012
................................................................................................................................. 274
Table 37 The 18th Politburo Standing Committee of the Communist Party of China .... 278
LIST OF FIGURES

Figure                                             Page
Figure 1 Equilibrium Levels of Repression and Loyalty under a Tinpot Dictator .......... 25
Figure 2 Equilibrium Levels of Repression and Loyalty under a Totalitarian Dictator ... 27
Figure 3 Equilibrium Levels of Repression and Loyalty under a Tyrant Dictator .......... 28
Figure 4 Equilibrium Levels of Repression and Loyalty under a Timocrat Dictator ...... 29
Figure 5 FDI Inflows by Region (%) ............................................................. 176
Figure 6 FDI Inflows by Province in Southeastern China ..................................... 177
Figure 7 FDI Inflows by Province in Northeastern China ...................................... 177
Figure 8 FDI Inflows by Province in Central China ............................................ 178
Figure 9 FDI Inflows by Province in Western China .......................................... 178
Figure 10 China’s Collective Leadership of the CPC ........................................... 226
ABSTRACT

THE PEOPLE’S REPUBLIC OF CHINA, 1949-2012: A POLITICAL ECONOMY PERSPECTIVE

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This dissertation explores the evolution of China from a socialist economy to an authoritarian market economy from a political economy perspective. I present here findings and insights from analytical history, theories, empirical analysis, and case studies.

Chapter 1 presents an analytical history of China from the Xia Dynasty to the Early Chinese Republic (2070 BC – 1949). I trace the history back to the beginning of Chinese civilization, and evaluate its progression over a span of more than 4,000 years in terms of social, political, economic, and philosophical developments. This chapter serves as a framework which is useful in understanding and analyzing the political economy of modern China.

Chapter 2 introduces a public choice evaluation of two key dictators, Mao Zedong and Deng Xiaoping, who shaped modern China. The first stage of the evaluation analyzes
the ideologies of these two dictators and their initial choice of economic institutions. I find that the ideological formations of both dictators are path dependent due to the unique Chinese culture stretched over a span of more than 4,000 years. I also find that the initial economic institutions utilized by both leaders are influenced by their upbringing. The second stage of the evaluation uses a model of dictatorship developed by Ronald Wintrobe (1998) to analyze Mao and Deng as dictators. I find that their behavioral differences fit into Wintrobe’s model of power-maximizing dictators, and more importantly, that Wintrobe’s model is compatible with the unique Chinese culture which shaped Mao’s and Deng’s behavior as dictators.

Chapter 3 provides a timeline of China’s political and economic transition between 1949 and 2012. Starting with Mao, his failed socialist economy ended in the chaos of the Cultural Revolution. After Mao, Deng established a blueprint for China’s market oriented growth model, which created the incentive for local government officials and self-interested individuals to engage in profit-seeking exchanges. After Deng, Jiang followed Deng’s footstep by promoting economic privatization which transformed China into an authoritarian market economy. After Jiang, Hu slowed down China’s market process by focusing on strengthening the existing state-owned enterprises, and increasing media censorship and repression. Xi will be the next leader of China, based on what is known of him, Xi’s pro-Mao political ideology is unlikely to be compatible with greater economic freedom in China.

Chapter 4 applies empirical analysis to case studies on the evaluation of economic freedom in China, from 1978 to 2000. First, using the Tiananmen Square protests of 1989
as a tipping point to the advancement of economic freedom in China, I empirically test
economic factors driving Chinese citizens’ increased awareness of freedom, which led to
these protests. Using statistical data at the provincial level and the number of protestors at
major cities, I find that domestic investment of the collective and the private sectors, FDI,
and the level of education at the provincial level are highly correlated with the number of
protestors in major cities. Second, I empirically test the impact of major reforms of state-
owned enterprises (SOEs) on the productivity increase of SOEs. I find that the
corporatization reform had a greater impact on the productivity increase of SOEs than
incentive based reforms. This finding conforms to the agency theory that increased
ownership diversification reduces the principal-agent problem in a firm.

Chapter 5 develops case studies on the impact of China’s WTO accession to
China’s sustained economic growth, from 2001 to 2012. First, I empirically test the effect
of government size at the provincial level to foreign investment inflow, and then repeat
the process to test the impact of foreign investment inflow in promoting the growth of
non-state enterprises. After filtering out the effect of geographic and economic
advantages, I find that smaller provincial government size, as measured by provincial
government expenditure, attracted greater foreign investment, while foreign investment
inflow are highly correlated with provincial economic growth driven by non-state
enterprises. Second, I analyze the impact of China’s rapid economic growth, driven by
both domestic market-oriented reforms and foreign investment, on the demand for rural
migrant workers in the urban areas. I find that even though the demand for rural migrant
workers has increased significantly in the 2000s, yet it has had little or no impact on the institutions of hukou or the household registration system.

Chapter 6 tests the theory of political survival developed by Bruce Bueno De Mesquita and Alastair Smith (2011) on China’s dictatorship. This theory predicts that the behavior of dictators depends on the relative size of the minimum winning coalition and the selectorate. Consistent with the theory, a smaller minimum winning coalition leads to greater private goods and less public goods in China. In addition to their theory, I find that the relative size of the different factions within the winning coalition matters just as much if not more in shaping the behavior of China’s dictators. Then, I use Xi’s presidential transition and Bo Xilai’s political downfall as a case study. I find that although the size of the minimum winning coalition most likely will decrease from 9 to 7 after Xi’s succession, there will be an increase in factional competition within the larger Politburo committee of 25 from a “bipartisan” system to a “multi-partisan” system. Finally, I evaluate China’s four alternative shifts from the status quo over the coming decade and the conditions that will determine which of them will most likely take place.

Chapter 7 assesses the past and future trend of economic and political freedom in China under the past leader Hu Jintao and the new leader Xi Jinping. First, using various economic and political indexes produced by the Fraser Institute, The Heritage Foundation and The Wall Street Journal, and the Freedom House, I find that China’s rapid growth in the past decade had both positive and negative impact on China’s economic freedom ranking, but this rapid growth had little or negative impact on China’s progress toward a more politically free state. Second, I evaluate China’s future economic and political
freedom, based on the composition of the 18th PSC. I find that the current PSC dominated by the princelings is very likely to pursue a conservative path, thereby maintaining the current economic and political freedom trend. In addition, I also find the current PSC dominated by the princelings also reduces the effectiveness of the Communist Party’s effort to combat corruption. As a result, the sustained level of rampant corruption is another sign that economic and political status quo is very likely to be maintained.
CHAPTER 1: SETTING THE SCENE – AN ANALYTICAL HISTORY OF IMPERIAL CHINA AND THE FIRST REPUBLIC

1. Introduction

China’s modern political economy under the Communist Party of China (CPC) was shaped by Marxist-Leninist theories of communist ideology. The aim of Marxist-Leninism ideology was to achieve a classless social structure with common ownership of the production system by means of a centrally planned economy. (Andrain, 1994) Mao Zedong, the founding father of the People’s Republic of China, was the first leader in the history of China to adopt Marxist-Leninist communist theory.

Under the influence of China’s extensive political, intellectual, and philosophical history, Mao did not simply adopt Marxism-Leninism; rather, Mao’s unique political ideology was derived from a mixture of Marxism-Leninism, and traditional Chinese intellectual thoughts, which is referred to as Mao Zedong Thought or Maoism. Mao Zedong Thought has been applied over the past several decades and is still the guiding principle in the CPC today.

In analyzing China’s modern political economy, Mao Zedong Thought is an important piece of information that can shed some light on the unique political, social, and economic development in China. Since Mao’s intellectual upbringing was influenced by the deep tradition of imperial China, Mao’s ideology can be traced back to the origin
of China’s expansive civilization, starting from the pre-modern dynasty of Xia to the last imperial dynasty of Qing.

China’s tradition over a span of 4000 years was uniquely shaped by the perception that China is the central country under heaven; therefore, it is called Zhongguo in Chinese or the “Middle Kingdom.” The earliest use of the name Zhongguo appeared in the compilation of documentary records Shangshu or “Classic of History” written in the Western Zhou Dynasty. The term Zhongguo was referenced under “皇天既付中國民越厥疆土于先王,” and was roughly translated by Scottish sinologist James Legge as, "The Heavens awarded the lands and peoples of Zhongguo to our ancestors." (Legge, 1961)

The name Zhongguo revealed a sense of superiority over all other countries, made evident in China’s diplomatic relations with foreign countries. Throughout China’s history, the Chinese showed little interest in securing overseas colonies and in the exchange of goods with foreigners. When China was faced with domestic and foreign conquests, and sometimes ruled by outsiders, the deep Chinese tradition could not be shaken in the land of the middle kingdom. As American political scientist and Nobel Peace Prize laureate Henry Kissinger puts it: “Even when China was weak or divided, its centrality remained the touchstone of regional legitimacy; aspirants, both Chinese and foreign, vied to unify or conquer it, then ruled from the Chinese capital without challenging the basic premise that it was the center of the universe.” (Kissinger, 2011)

Therefore, to fully grasp the modern political economy of China shaped by the Chinese dictatorial leaders, Mao Zedong, Deng Xiaoping, Jiang Zemin, and Hu Jintao,
we must trace back through time to seek the root from which Chinese social, political, economic, and philosophical thoughts developed.

2. Imperial China: From Xia Dynasty to the Qing Dynasty (2070 BC – 1912 AD)

The pre-modern China dates back to Xia Dynasty (2070 – 1600 BC), which marked the beginning of Chinese civilization. However, the existence of Xia lacked written historical evidence, and is still under debate between archeologists and historians. What is certain is the existence of the Shang Dynasty (1970 – 1045 BC), the second dynasty which emerged around 1570 BC following Xia. Shang ruled in the northeastern regions of China. Shang was an aristocratic society, with aristocratic clans supporting the administration of the state. During this period, bronze technology developed, including sophisticated bronze ritual vessels, and weapons that contributed to the strength of the Shang military.

Shang co-existed with other cultures, and shared the geographic locale of China Proper. Since these different cultural groups shared the same territory of China Proper, they were constantly at war with each other. One of the groups was the Zhou people in the West. In 1045 BC, the people of Zhou defeated Shang and became the third dynasty in China, lasting from 1045 BC to 221 BC. The Zhou Dynasty was broken down into the Western Zhou period (1045 – 771 BC) and the Eastern Zhou period (770 – 221 BC).

Zhou was described as a feudal state, with a weak centralized state, and over seventy feudal states controlled by hereditary lords. Without a strong centralized state, Eastern Zhou was dominated by war, with the feudal states fighting and making alliances. Eastern Zhou was further broken down into the Spring and Autumn period (770 – 475
BC), and then the Warring States period (475 – 221 BC) in which seven powerful states emerged as a result of fighting and making alliances.

Eastern Zhou was a significant period in China’s history for the developments of Confucianism, Daoism, and Legalism. These three schools of political and moral philosophies shaped political, social, and economic developments in China’s imperial era. More importantly, these philosophies played an important role in the formation of Mao Zedong Thought, which was, and still is, the central ruling ideology used by the authoritarian leaders of the CPC.

During the Warring States period, Qin was the most developed of the seven states in terms of bureaucratic structure and military strength. In 230 BC, the King of Qin, Ying Zheng, declared war against the other six states. This led to the unification of China. In 221 BC, Ying Zheng became the first emperor of a unified China and assumed the name Qin Shi Huangdi. (World History: Volume I: To 1800, 2006) Qin Dynasty (221 – 206 BC) was the first to apply Legalism in China’s political and social structure. The essential principle of Legalism was to obey the rule by law. It was the ruler who was empowered with authority or shi. Legalism believes in the supremacy of the central government over individual autonomy.

Qin Shi Huang was one of the most influential figures in China’s history for unifying China. However, his greatness and vision were overshadowed by his ruthless and tyrannical rule over China. Qin Shi Huang was often compared by many to Mao for creating a harsh legal system, burning all intellectual books, destroying the Confucian culture, and killing scholars. Mao may have partially modeled his tyrannical political
policy after Qin Shi Huang, made evident in his 1958 speech to party cadre. In his speech, Mao made the comment that he had surpassed Qin Shi Huang in the suppression against intellectuals: “He buried 460 scholars alive; we have buried forty-six thousand scholars alive… You [intellectuals] revile us for being Qin Shi Huangs. You are wrong. We have surpassed Qin Shi Huang a hundredfold.” (Mao, 1974)

The result of Qin Shi Huang’s harsh ruling led to rebellions by poor peasant groups. One of the rebellious groups, led by Xiang Yu, defeated the Qin army and caused the surrender of Qin’s third emperor. However, Xiang Yu’s ideal of reviving the feudal state was rejected by some feudal lords. His opposition, Liu Bang, gained the support of those feudal lords, defeated Xiang Yu, and established the Han Dynasty (202 BC – 220 AD).

Han built upon Qin’s centralized bureaucratic structure, but abandoned the harsh laws and regulations used by Qin. An important aspect of Han was the adoption of the Confucian philosophy and appointment of Confucian scholars in civil services. During this period, there took place intensive cultural development, and interaction with the outside world. Han interacted with Central Asia, such as China’s Inner Asian peripheral areas, and India through the Silk Road. Culturally, Buddhism entered China through the Silk Road and, with Daoism, became part of Chinese religion.

After Liu Bang, his son, Emperor Wendi, and Wendi’s son, Emperor Jingdi, made further advances on Han’s economic development, turning Han into a prosperous dynasty. Han experienced significant population growth combined with increased urbanization; intensive agricultural cultivation using sophisticated irrigation methods;
enhanced production of industrial goods; unprecedented trade and exchange with the outside world; and the abolishment of the communal and aristocratic well-field system so that land could be traded. (Sadao, 1986)

On the political front, Emperor Jingdi’s, son Emperor Wudi, expanded the size of the Han Empire by defeating the nomadic-based Xiongnu in the north frontier of China. More importantly, during Wudi’s rule, major political reforms took place. The most significant of those reforms was the institution of bureaucratic recruitment. Prior to this reform, qualification into the administration depended on marquisate. With this institution, educated Confucian talents were recruited into the administration through a selection process while preserving the selection method based on marquisate. Years later, a nomination process was adopted so that senior officials could nominate educated talents for civil positions. In 124 BC, the imperial academy was built to accept a limited number of students to study the Confucian text. They were eligible for official appointments once they passed the Bureaucratic examination.

Han’s dynamic political, social, and economic developments contrasted significantly with Qin’s legalist state which existed solely for the purpose of strengthening the power of the Qin Emperor. Han’s founding Emperor Liu Bang’s greatness lay in his ability and willingness to abandon the ruthless one-man decision making legalist regime; to promote reforms that resulted in a prosperous dynasty; and to create an institutional structure that encouraged his successors to follow his vision. Interestingly, in modern China, the visionary Deng Xiaoping shared identical traits with Liu Bang of Han. Both Liu Bang and Deng Xiaoping came to power during the time of
major political turbulence caused by the ruthless tyrants before them, Qin Shi Huang and Mao, respectively. It is not a coincidence that, in different periods of time, Liu’s and Deng’s visionary approach to reforms succeeded after both Qin Shi Huang and Mao ruthlessly destroyed China’s culture and killed huge numbers of people in order to achieve their own ideologies.

After Emperor Wudi, Han faced gradual decline. The downfall of Han in 220 was followed by a period of frequent division and unification from 220 to 589, starting from the Three Kingdoms (220 – 280), Jin Dynasty (265 – 420), to the Southern and Northern Dynasties (420 – 589). Eventually, China was unified in 589 by Yang Jian, a powerful military commander of the Northern Zhou society. Yang Jian became the first Emperor of the Sui Dynasty (589 – 618). Sui was short lived, but it served as a transitional dynasty before the great Tang Dynasty (618 – 907).

Tang is considered the golden age of China’s imperial era. Tang was a period of social, cultural, and technological progress. The Tang government was filled with highly-educated, aristocratic men and built a powerful army that was unparalleled at the time. The Tang government harnessed a productive agriculture, intensive trade and cultural interaction with the Middle East, India, Persia, and the Central Asia, and expanded the empire into the northern Vietnam and Korean peninsula.

As great as the Tang Dynasty was, it faced decline in the middle of the 8th century when the Tang commander, An Lushan, led the An Shi Rebellion in December 755. During this period, Tang’s emperor, Xuanzong, was increasingly attracted to the search for personal enlightenment; and his infatuation with his beautiful consort, Yang Guifei,
distracted him from managing the administration. On the military front, the military system was divided into nine sectors controlled by nine military governors, each with aristocratic background and close ties to the bureaucracy.

In the 740s, military reform allowed the appointment of non-Chinese governors. At that time, An Lushan, half-Sogdian and half-Turkish, was a soldier in the Tang army and was appointed Governor of three garrisons in the north. His military success as Governor earned him the trust of Emperor Xuanzong and his consort, Yang Guifei. The An Shi rebellion was triggered by political conflict between An Lushan and Sichuan governor, Yang Guozhong. Yang Guozhong was eager to remove An Lushan from power.

The rebellion was fought in eight years with the support of local officials in different regions. An was able to capture the capital of Chang’ an and forced Emperor Xuanzong to abdicate his throne to crown prince Emperor Suzong. Once in power, Emperor Suzong immediately appointed generals Guo Ziyi and Li Guangbi to suppress the rebellion, and was able to successfully recapture Chang’an. An Lushan was eventually killed by his own son. The rebellion signified the beginning of Tang’s decline. Further decline followed in the mid and late 800s when the young emperors of Tang lost authority over courts and different factions were in conflict with one another.

The fall of the Tang Dynasty in 907 led to another period of political upheaval and disunity named Five Dynasties and Ten Kingdoms (907 – 960). During this period, China was divided into three territories. The north-east territory was controlled by the
Liao Dynasty. The rest of China was further divided, with the northern territory controlled by five dynasties and the southern territory controlled by ten kingdoms.

In 960, General Zhao Kuangyi from one of the five dynasties seized power and established the Song Dynasty (960 – 1276). Zhao was able to first control the throne and then, without engaging in battles, persuaded provincial commanders into submission by offering them rewards. Zhao’s success in the north allowed him also to unify territories south of the Yangzi River. After Zhao’s death in 976, his brother, Emperor Taizong, continued with the unification process by obtaining the independent kingdoms of Zhejiang and Shanxi. However, Song’s army was not strong enough to conquer the Liao Dynasty. Instead, both parties reached an agreement whereby Song would contribute to Liao’s annual military expenses in exchange for peace.

In the initial stage, Song experienced market-based economic and technological developments. Merchant families were prominent and flourished with private trade activities not controlled by the government. During this period, guilds were formed by artisans and merchants who standardized both wages for their workers and prices of their goods. (Ebrey, Walthall, and Palais, 2006) Song was the first in world history to print government issued paper money, known as Jiaozi. As a result of these significant advancements in agricultural production and technology, there occurred mass production of commodities and high rates of urbanization. This advancement in science and technology was unparalleled in Chinese history. Most significant of all was the development of gunpowder. The formulas for gunpowder were initially written in the Wujing Zongyao manuscript. (Needham, 1986e) Other scientific developments included
a mechanical odometer device, a south pointing chariot, a magnetic compass, movable type printing, and many other less significant inventions.

As a result of Song’s rapid economic and technological developments, capitalism started to take shape. However, the prosperity experienced in the early stage of the Song Dynasty could not be sustained. Therefore, this process did not lead to industrial revolution. (Roberts, 2006) Hungarian sinologist, Etienne Balazs, observes that rapid economic and social changes took place in the Tang-Song period, when the power of the state was not dominating the country. Once the state of Song gained more power and control, individual freedom and private property rights became more constrained, which prevented Song’s advancement to a capitalist society. (Balazs, 1964)

The decline of Song was followed by Mongol invasions of Asia and Eastern Europe led by Genghis Khan throughout the 13th century. This conquest halted after the death of Genghis Khan in 1226, and the death of his third son Ögedei Khan in 1234. At that time, north China had already been defeated by the Mongols. When the fourth Khan of the Mongol Empire, Möngke, came into power, he resumed the Mongol conquest. Möngke continued the conquest of China and was able to control south China by defeating the kingdom of Nanzhao. In 1271, the Yuan Dynasty (1271 – 1368) was established by Kublai Khan, younger brother of Möngke, after Möngke appointed him to administer north China.

Yuan’s short life was caused by harsh winters, flood, droughts, epidemics, a decline in agricultural productivity, and more importantly, a weak and inefficient
This combination of environmental, economic, and political crises led to widespread peasant rebellions in the 1350s and 1360s.

One of those rebellions, led by a poor peasant, Zhu Yuanzhang, succeeded in defeating Yuan and other existing rebel groups. After other major warlords surrendered to Zhu in January 1368, Zhu declared himself Hongwu Emperor and established the Ming Dynasty (1368 – 1644). Ming was the last imperial dynasty ruled by the Chinese Han people. As the first emperor of Ming, Zhu was able to secure enough power to establish a state of absolutism. This was achieved by abolishing the post of chancellor, which allowed Zhu to have a direct control over the central government.

To assume further control, Zhu also established the Jinyi Wei, a secret military police organization that served directly under the emperor. The Jinyi Wei was initially used as personal bodyguards to Zhu and then developed into a military and intelligence organization. The Jinyi Wei was considered an autonomous organization with the authority to overrule the judicial system, collect military intelligence, and engage in the arrest, interrogation, and punishment of citizens and noblemen. Since the Jinyi Wei served no one else but the emperor, they were considered the single most powerful organization in the Ming government, and were responsible for the death of over 100,000 lives through purges initiated by Zhu Yuanzhang over a period of three decades.

The shift of power from the emperor to the eunuchs took place gradually under Yongle Emperor, the grandson of Zhu. Under Zhu, eunuchs were forbidden to interfere with government affairs. However, starting with Yongle and the proceeding emperors,
eunuchs were entrusted with political and military power. Eunuchs were appointed as the head of Eastern Depot secret police organization, personal secretaries for the emperor, and had their own palace eunuch school to receive education. One of the well-known eunuchs, Zheng He, became a fleet admiral in charge of seven major naval expeditions between 1405 and 1433. Zheng’s fleet travelled to Arabia, Brunei, East Africa, India, Malay Archipelago, and Thailand. These expeditions were possibly the “largest scale manhunt on water in the history of China.” (Deng, 2005)

In time, as eunuchs gained increased power over incompetent emperors, widespread corruption and factional struggle became unmanageable. This combined with frequent floods and droughts in the early 1600s led to nationwide rebellions. Among the major rebellion leaders, Li Zicheng, with an army of over a million men, succeeded in defeating the Ming army in the north and, as well, captured the northern capital of Beijing in 1644. Li’s victory was only temporary because Li was faced with other rebel groups north of the Yangzi River; powerful Ming army commander, Wu Sangui, guarding the Shanghaiguan gate; and the Manchu in the northeast region above Shanghaiguan.

After Li captured Beijing, he took Wu Sangui’s immediate family as hostages in Beijing. On the other hand, Wu’s uncle and cousins were serving the Manchu Dynasty. Therefore, Wu was faced with the option to either support Li or Manchu’s prince, Dorgon. When Wu eventually sided with Dorgon, Li executed Wu’s father. Wu opened the Shanghaiguan gate for the Dorgon’s Manchu army to enter into China. Once they entered China, Dorgon incorporated Wu’s army under his command, and captured
Beijing by defeating Li Zicheng. Then the Manchu army marched south and captured other regions by defeating the Ming army and other rebel groups. The alliance between Wu and Dorgon of Manchu was the determining factor for Dorgon’s conquest of China and the establishment of the Qing Dynasty (1644 – 1912). Even though Dorgon did not serve as the emperor of Qing, his nephew Shunzhi became the first emperor of Qing.

Qing was the last dynasty of China and it was a time of peace, prosperity, and a strong bureaucratic system. Qing’s government structure was based on Ming’s structure, with a strong central government and concentrated power in the hands of the emperor. Starting with Kangxi emperor, the “palace memorial” system was developed to strengthen the power of the emperor. This system allowed high-ranking officials to submit government memorials directly to the emperor, bypassing the bureaucracy in order to enhance the speed and accuracy of information flow to the top.

The top-down political structure was a combination of central bureaucracy and 1528 counties governed by county officials. County officials were responsible for collecting county taxes, investigating civil and criminal cases, managing and maintaining public works, administering civil service examinations, and establishing social order.

The height of the Qing Dynasty took shape under Qianlong, the fourth emperor of Qing. Under Qianlong, small government was the best description for Qing’s bureaucratic system. Government intervention and taxation was at the minimum level in China’s society, as was the avoidance of government intervention in the economy. Essentially, this was putting Neo-Confucian principles into practice. (Tanner, 2010) Total revenue shrank gradually as a percentage of total economic output. (Rowe, 2003) The
borders of China were expanded to its greatest extent during this time period. As a successful leader, Qianlong conquered the Chinese Turkestan and renamed it Xinjiang.

However, the height of the Qing Dynasty was soon followed by decline, all under Qianlong. In his older years as emperor, Qianlong was indulged with power and glory, and abdicated day-to-day governance to corrupt officials such as Yu Minzhong, and to his highest ranked minister, Heshen. When Heshen was executed for corruption after Qianlong stepped down, Heshen’s accumulated personal wealth was 900,000,000 taels of silver, equivalent to the total of 12 years of Qing’s Treasury surplus.

Internal problems, followed by the Western invasion of China, caused the fall of the Qing Dynasty in 1912. The decline of farmland per family as a result of high population growth, droughts, ethnic tension, and government ineptitude caused popular uprisings. Major rebellions such as the White Locus Rebellion in 1774, the Taiping Rebellion in 1850, and the Boxer Rebellion in 1898 took place as anti-Manchu movements, which threatened the stability of the Qing Dynasty. The Taiping Rebellion in particular, was the costliest civil war in China’s history in terms of human life, and was the second bloodiest war of any kind after WWII. Between 20 to 30 million people died during the 14 years of the Taiping Rebellion. (*Encyclopædia Britannica*, 2011)

The Qing Dynasty’s external problems started in 1893 with the First Opium War between the United Kingdom and the Qing Dynasty. Intensified trade activities between China and Britain, exporting tea and opium, respectively, caused nationwide addiction to opium in China. When the Qing government tried to ban the opium trade, Britain declared war on China. Suffering major defeat, the Qing government realized that they
were no match against the western military. The Qing government was forced to sign the Treaty of Nanjing and ceded Hong Kong Island to Great Britain. The First Opium War was soon followed by the Second Opium War in 1856, when the Qing government refused to re-negotiate the Treaty of Nanjing with Great Britain. As a result, the Qing government faced yet another defeat. The British demanded unlimited access to all Chinese rivers.

During the rule of Empress Dowager Cixi, China was faced with the First Sino-Japanese War in 1884. The result was similar to the Opium Wars: the Beiyang fleets were annihilated by the Japanese naval force, and China lost the port of Weihaiwei. The First Sino-Japanese War was followed by the entry into China of the Eight-Nation Alliance. Cixi declared war on all eight nations but ended up losing Beijing, so she fled to Xi’an. After the death of Cixi in 1908, Puyi ascended the throne.

In this chaotic period, mass social disorders and Western invasions became unmanageable, and the fall of the Qing Dynasty was inevitable. The Wuchang Uprising in October 1911 became the determining factor for the fall of the Qing Dynasty in 1912. The collapse of the Qing Dynasty brought to an end the over 2000 years of the imperial era in China. The establishment of the Republic of China, after the Wuchang Uprising, signified a new era of modern China, and a break from traditional imperial rule.

3. The Early Chinese Republic (1912 – 1949)

After the fall of the Qing Dynasty, the Republic of China (ROC) was founded by the Kuomindang (KMT) political party. KMT’s leader Sun Yat-Sen was elected the first provisional president of ROC. However, the central government run by the KMT was
fragile because of the coexistence of two other political and military factions: prime minister Yuan Shikai who was also the Commander of the Beiyang fleets, and major wealthy Chinese warlords. Both Yuan Shikai and the wealthy warlords wanted to take over the central government in order to establish a strong central authority during this chaotic period. Therefore, a clash took place among the KMT led by Sun Yat-Sen, Commander Yuan Shikai of the Beiyang fleets, and wealthy Chinese warlords.

Because of KMT’s weak political and military status, Sun Yat-Sen stepped down as the president of ROC in just a short period of time. He was succeeded by Yuan Shikai. Yuan was able to convince Sun to transfer the presidency to him. In return, Yuan promised to arrange for the abdication of China’s last emperor Puyi. (Busky, 2002) Besides, Yuan Beiyang’s fleets were a major threat to KMT as well. Yuan’s immediate action after becoming the president was to crackdown on KMT. Sun Yat-Sen fled to Japan, and then came back to wage war on Yuan with the Second Revolution in 1913, but he failed completely.

While in office, Yuan was able to secure enough power to form a centralized government. With this power in hand, Yuan declared himself the emperor of China in December 1915. However, just few months later, in June 1916, Yuan passed away. With Yuan’s death, China was left once again with a dispersed central authority and political struggle between the KMT and Chinese warlords.

A few years later after Yuan’s death, KMT’s leader Sun passed away in March 1925. After Sun’s death in 1925, a power struggle broke out between the KMT left wing’s Wang Jingwei, and the KMT right wing’s Chiang Kai-shek. Wang Jingwei was
associated with the left wing because of his support for more radical pro-Soviet policies, while Chiang Kai-shek was associated with the right wing because Chiang’s father was a wealthy landlord. However, in practice, both wings suppressed wealthy landlords and merchants.

Wang took Sun’s place as the chairman of the Nationalist Government and Chiang became the commander-in-chief of the National Revolutionary Army (NRA) in 1926. In the same year, Chiang launched the Northern Expedition military campaign to defeat the warlords controlling northern China in order to unify China and to strengthen Chiang’s personal political power. The expedition allowed Chiang to become the Director of the State Council in 1928, a position equivalent to the President of China.

Having assumed control of China, Chiang followed Sun’s ideological footsteps in order to build democracy in China. The three ordered steps were in the order of military rule, political tutelage, and then constitutional rule. Since military rule has already been accomplished, Chiang began to implement political tutelage in 1928. The ultimate objective of political tutelage was to turn China into a modern and well-functioning state.

As a political leader, Chiang cared about his personal consumption and the consumption of his top officers. Chiang was not known for using repression and his policies were not popular among the wealthy and peasant groups, so he did not gain loyalty as a leader in China. The mixed use of repression and loyalty instruments that Chiang used to maximize consumption shows that he was a Tinpot dictator. (Wintrobe, 1990 & 1995)
Chiang Kai-shek, like Sun Yat-Sen, promoted nationalism and was opposed to capitalism. To prevent the spread of capitalism, Chiang minimized the political power of the capitalists, blocking their ability to exercise their voice in his regime. Chiang was particularly hostile toward the capitalists in Shanghai, where he often attacked and confiscated their wealth, using it to support his military activities. Chiang facilitated corruption in the KMT by giving his loyal officers political power, wealth, status, and land. (Fenby, 2005)

During the era of political tutelage, political efforts were made to improve the legal and penal systems. On the economic front, banking and currency systems were reformed, prices were stabilized, railroads and highways were built, the production of agricultural and industrial products were expanded, and public health facilities were improved. (Fenby, 2005)

Chiang spent a majority of his military effort on eliminating the force of the Communist Party of China (CPC). Chiang saw the CPC as a great barrier to his political power and stability. Therefore, the Northern Expedition military campaign was not only used to destroy warlords, but also to destroy the CPC. During the Northern Expedition in April, 1927, a large military movement was organized to purge the Communists in Shanghai. This military movement caused the split between the KMT and the CPC, which immediately led to the long standing Chinese civil war between the KMT and the CPC.

Following the purge of the Communists in Shanghai, the CPC organized a military revolt known as the Nanchang Uprising in August 1927. After the CPC
successfully took over Nanchang, and facing counter-attacks from the KMT, they retreated down to the south, in the direction of the Guangdong province. To resist KMT’s military force, the CPC spread their influence in the countryside, recruiting peasants while escaping from KMT’s attack. The massive retreat by the CPC, begun in October 1934, from the south to the northern and western regions, covering 12,500 kilometers, was known as the Long March.

During the Long March, Mao Zedong was one of the leaders of the CPC and the Red Army. Mao Zedong’s effective control over the First Red Army gained him great popularity in the CPC. Also, Mao’s Eight Points of Attention strictly prohibited the Red Army from harming and disrespecting the peasants, even under the condition of low food supply. The Eight Points of Attention won the support of the peasants, which became a major factor in defeating the KMT in late 1940. As historian and political scientist Roderick MacFarquhar stated: “The greatest strategic retreat in military history turned Mao into a living legend.” (MacFarquhar and Schoenhals, 2005)

The Chinese Civil War between the KMT and the CPC was interrupted by the Japanese invasion of Manchuria in 1931, and the Second Sino-Japanese War in 1937. The Japanese army invaded China in July 1937 and moved quickly to invade the cities of Nanjing, Wuhan, and Chongqing, forcing Chiang’s army to move inland. The Japanese invasion combined with Chiang’s ineffective, Tinpot dictatorship further exacerbated China’s poor economic condition. The average annual rate of industrial growth in China was 4.5 percent from 1936 to 1942. This growth was much lower when compared to the 13.8 percent from 1912-1920, and 8.3 percent from 1923 to 1936. (Eckstein, 1975)
The Japanese invasion forced the KMT and the CPC to work cooperatively in combating the Japanese army. The Japanese invasion ended after the United States dropped atomic bombs on Hiroshima and Nagasaki in 1945. The Japanese troops were forced to surrender to the KMT. The Chinese Civil War immediately resumed in the next year. This time around, the CPC grew more powerful by gaining greater popularity among the peasants. They took control of substantial amounts of Japanese weapons, and, with the help of the Soviet Union, they took control of northern Manchuria.

Over the years of continued clashes between the two parties, the CPC kept winning by strategically avoiding the strong military forces of the KMT, and thus were able to seize major cities. After the CPC seized Chengdu in December 1949, the last city controlled by the KMT, Chiang Kai-shek was forced to retreat to Taiwan. Chiang’s defeat in the Chinese Civil War was due also to the misuse of his political power in the KMT, and to the corruption among his top officers. (Chang, 2008)

After KMT’s defeat, the People’s Republic of China (PRC) was established on October 1st, 1949, and Mao became the Chairman of PRC. Mao became the real starting point of China’s transformation from the imperial era to a Communist society. Mao’s contribution to China’s unification and transformation earned him the title “Great Leader Chairman Mao.” However, as a leader of China, Mao was not able to break away from the influence of rich, traditional Chinese thoughts. The ideological conflicts within Mao during this period of China’s social transformation eventually distorted his mind and led him to use extreme political weapons.
CHAPTER 2: MAO ZEDONG VERSUS DENG XIAOPING – A PUBLIC CHOICE EVALUATION OF TWO KEY DICTATORS WHO SHAPED MODERN CHINA

1. Introduction
To analyze China’s political and economic transition from socialism to authoritarian capitalism, it is critical to ponder the political and ideological motives of Chinese leaders. In a centrally planned economy like China, the central planner, or the ruler, has absolute political power to implement political and economic policies; therefore, he dictates the social transformation and development of his country over time.

Chinese leaders with absolute power can be categorized as dictators. According to dictionary.com, a dictator is a ruler with absolute and unrestricted control of government but without hereditary ascension such as an absolute monarch. (Dictionary.com, 2011)

Dictators are not all the same. Even though they are endowed with absolute power, what they do with their power and how much power they use for abusive purposes differs.

The behavioral differences among dictators were observed and categorized by economist, Ronald Wintrobe (1998). According to Wintrobe, there are four types of dictators, (totalitarian, tyrant, tinpot, and timocrat), based on the levels of repression and loyalty used by the dictators to achieve their utility maximizing objectives. Totalitarians use high repression and create high loyalty to maximize power. Tyrants use high repression and create low loyalty to maximize power. Tinpots use low repression and
create low loyalty to maximize personal consumption. Timocrats use low repression and create high loyalty to maximize personal consumption. (Wintrobe, 1990 & 1998)

2. The Dictator’s Dilemma and Autocratic Equilibrium

To maximize power or consumption, a dictator is essentially engaged in a production process. The production process can be represented with a production function, where the inputs are loyalty and repression, and the output is power. Maximizing consumption in this production function is the same as minimizing power. Since producing power requires resources, minimizing power minimizes the resources required to produce power, which increases the resources available for the dictator’s consumption. Given the right levels of loyalty and repression, power can either be maximized, or minimized (maximize consumption).

Resources spent in the production of power are allocated between the level of repression implemented and the amount of loyalty acquired by the dictator. Repressive techniques implemented by the dictator involve removing political opposition, producing repressive legislation, monitoring obedience, and punishing offenders. (Wintrobe, 1990 & 1998) An increase in repression would result in an increase in the level of policing obedience, the severity of punishing the disobedient, and the range of activities prohibited. Loyalty on the other hand, is acquired by the dictator through the distribution of political rents. Since resources are limited, the dictator faces a trade-off between the level of repression and the amount loyalty. Given the resource constraint, the dictator has to optimize the allocation of resources between these two inputs in order to maximize or minimize the output (power).
Given this general understanding of the dictator’s production process to produce power, how do the utility objectives and constraints of the four types of dictators affect the various levels of repression and loyalty that they use? For example, why do totalitarian dictators use high repression and create high loyalty, whereas tinpot dictators use low repression and create low loyalty? Before examining the four types of dictators, why do dictators go through the trouble of creating loyalty in the first place? Why not just use repression alone?

Dictators have a greater ability and tendency to use repression to achieve their political objectives in comparison with democratic leaders. However, repression alone also creates a problem for the dictator. As observed by Wintrobe: “The use of repression breeds fear on the part of a dictator’s subjects, and this fear breeds a reluctance on the part of the citizenry to signal displeasure with the dictator’s policies….. The more his repressive apparatus stifles dissent and criticism, the less he knows how much support he really has among the population.” (Wintrobe, 1990 & 1998) The dictator’s use of repression creates fear among people, which reduces their likelihood to provide feedback to the dictator. The effect of this asymmetric information creates fear within the dictator as well because he doesn’t know what his people think of him. This is essentially the dictator’s dilemma.

To resolve the dictator’s dilemma, dictators are incentivized to draw support (loyalty) from the citizens, instead of using repression alone. Because of the issue of credible commitment and the problem of enforcing it, the support of a dictator comes in the form of loyalty. “But, again, like democratic politicians, there is no legal way to
enforce these ‘political exchanges’ and so they try to obtain loyalty as a way of guaranteeing support.” (Wintrobe, 1990 & 1998) As a result, dictators have to rely on varying combinations of repression and loyalty in order to exercise power.

Given the dictator’s dilemma, the supply of loyalty becomes a critical factor for a dictator’s survival. There are three variables affecting the supply of loyalty to the dictator; the level of repression, the price of loyalty, and the economic performance of the country. At a low level of repression, an increase in the level of repression increases the supply of loyalty because it becomes riskier for people to interact with oppositions. An increase in the price of loyalty increases the supply of loyalty in terms of increased political rents. An increase in the economic performance also increases the supply of loyalty because the increase would be likely to increase the size of political rents.

Once the input variables of repression and loyalty in the production process of dictators is understood, examination can take place of each of the four types of dictators based on their individual utility objectives and constraints. To begin, tinpot dictators are analyzed to see how their utility objective and constraints affect their decisions on the use of repression and loyalty.
Figure 1 shows a tinpot dictator’s choice of repression and loyalty given his utility objective of maximizing consumption and his budget constraint. Isopower line $\pi_{min}$ represents the condition which the tinpot dictator obtains the minimum level of power necessary for him to stay in office while maximizing his consumption. The dictator’s budget constraint or expenditure function, $B = P_R R + P_L L$, is represented by the budget line BB, which depends on the price of repression, the level of repression, the price of loyalty, and the amount of loyalty. The expenditure function B determines the resource costs for the dictator to stay in office.

The equilibrium condition is where the dictator’s budget line BB is tangent to the lowest isopower line $\pi_{min}$ at point E. This equilibrium point determines the dictator’s optimum levels of repression and loyalty required to minimize his power and maximize his consumption. Isopower lines $\pi_1$ and $\pi_2$ are not the optimum because more resources
allocated to repression and loyalty are required than what is necessary for the dictator to stay in office, which would take away part of the dictator’s consumption. An isopower line below $\pi_{min}$ would result in the dictator being deposed.

The supply of loyalty to the tinpot dictator, $L^S = L^S(R, P_L, PE)$, is endogenously determined by the level of repression $R$, the price of loyalty $P_L$, and the economic performance of the country $PE$. Increasing the price of loyalty increases the supply of loyalty, and increasing the economic performance also increases the supply of loyalty.

The level of repression has two effects on the supply of loyalty: an income effect and a substitution effect. An increase in the level of repression through the income effect increases the likelihood of people being repressed, thus reduces the supply of loyalty. The substitution effect, on the other hand, increases the risks of becoming disloyal or reduces the attractiveness of dealing with oppositions, thus, increases the supply of loyalty. At a lower level of repression, the substitution effect is much greater than the income effect. Therefore, an increase in the level of repression would increase the supply of loyalty, which is represented by the upward sloping $L^S$ line in figure 1.
On the opposite extreme of tinpot dictators are totalitarian dictators. They use high level of repression and create high amount of loyalty to maximize their power. Since totalitarian dictators seek to maximize power and care less about personal consumption, they, therefore, face a different constraint from tinpot dictators. Figure 2 shows a totalitarian dictator’s choice of repression and loyalty given his utility objective of maximizing power and his constraint. To maximize power, a totalitarian dictator needs to implement a high level of repression and acquire a high amount of loyalty. Since the totalitarian dictator’s supply of loyalty curve $L^s$ is upward sloping, increase in the level of repression would also increase the amount of loyalty, which would result in a corner solution with perfect repression.

The corner solution is the equilibrium condition at point $E_0$, where the $L^s$ curve is tangent to the highest attainable isopower line $\pi$. At this equilibrium condition, both the
level of repression and the supply of loyalty are high. However, perfect repression cannot be achieved due to the income effect of the supply of loyalty, which is represented by the backward bending portion of the dictator’s $L^s$ curve. At a lower level of repression, the substitution effect overcomes the income effect. But at a higher level of repression, the income effect dominates the substitution effect, which reduces the supply of loyalty. The equilibrium condition also implies that an increase in the level of repression at the margin reduces the supply of loyalty.

![Figure 3 Equilibrium Levels of Repression and Loyalty under a Tyrant Dictator](source: Wintrobe, R., (1998), The Political Economy of Dictatorship, Cambridge University Press, P81.)

Like totalitarian dictators, tyrant dictators also seek to maximize their power, and they do so by using a high level of repression and creating a low amount of loyalty. The low supply of loyalty is contributed to the incapability of the incomplete political institutions to monitor and reward loyalty. Therefore, the supply curve of loyalty $L^s$ is
highly steep. The equilibrium condition for a tyrant dictator is at $E_0$ on figure 3, with a high level of repression and a low supply of loyalty.

There are three implications of tyrant dictators provided by the equilibrium condition. First, tyrant dictators use violence to maintain their power. Second, tyrant dictators do not care at all about the material interests of their people. Third, tyrant dictators derive satisfaction from restraining their subjects. (Wintrobe, 1990 & 1998)

The rarest case among the four types of dictators is Timocrat dictators. They are considered benevolent dictators because they care about the welfare of their people. Thus, a timocrat dictator seeks to maximize the welfare of the population, which is represented by the utility function $\sum_i w_i U_i [Y_i (1 - t) + G_i]$. The timocrat dictator’s utility depends on citizen $i$’s income and the size of the gift given by the dictator. The dictator also faces three constraints.
The first constraint is that the dictator’s power cannot fall below the minimum power required to stay in office, which is represented by $\pi(L, R) \geq \pi_{\text{min}}$. Even though the timocrat dictator is benevolent and cares about the welfare of his people, reducing his power below the minimum would result in him being deposed by another dictator who holds more power or who is less generous than the timocrat dictator. For this reason, the dictator would choose a low level of repression which ensures that $\pi(L, R) \geq \pi_{\text{min}}$.

Another reason for applying repression is because it increases the supply of loyalty, which is represented by the upward sloping $L^S$ curve on figure 4. The second constraint is the dictator’s budget $F + tY(G) = P_L(R, G)L + P_R R + G$, which is determined by the taxation revenue on the citizens, and foreign income. This budget is then allocated on repression, loyalty, and gifts to the citizens.

Given the timocrat dictator’s utility objective of maximizing the welfare of his people and the constraints of power and his budget, the dictator’s equilibrium condition is at point E, where his isopower line $\pi_{\text{min}}$ is tangent to his $BB$ line. At this equilibrium point, the dictator chooses to implement a low level of repression while creating a high amount loyalty.

By using Wintrobe’s general model on dictatorship, we shall define China’s dictators in general as totalitarians, with the exception of Mao, during and after the Cultural Revolution in 1966. Through the class struggle against the liberal bourgeois, Mao turned himself into a tyrant by persecuting many millions of people in China. Besides Mao’s deviant behavior, totalitarian leaders of China have used high levels of repression while maintaining a strong loyalty base from the population.
3. Limitations of the Wintrobe Categorization

However, Wintrobe’s general model has its limitations. The model does not account for the ideological differences among Chinese dictators shaped by China’s deep social, cultural, and philosophical formation over the span of 4000 years. For example Mao Zedong’s excessive use of power to create continuous revolutions, and to abolish the traditional Chinese culture by burning all intellectual books, destroying the Confucian culture, and killing intellectual scholars, cannot simply be explained by Mao’s motive of maximizing power. On the other hand, Deng Xiaoping’s reversal of Mao’s harsh political repression and economic central planning through market oriented reforms and constraining term limits of Chinese leaders also contradicts a totalitarian’s objective of maximizing power.

Ideological formation of the Chinese dictators may also be affected by factional political struggle. The CPC consists of many political factions with ideological differences all competing for political and economic resources for their members. Potential candidates competing for office have to promote the ideology of their faction or party. Whether these candidates personally agree with the ideology of their faction or party doesn’t matter. They have to follow it in order to draw the support of the members of their faction or party. In a way that is similar to a democratic system, candidates competing for the votes of the general public have to associate themselves with the parties to which they belong. A person without party association would not have enough support to become a potential candidate.

Another aspect of Wintrobe’s general model of dictatorship is the assumption that dictators are endowed with absolute power at the time of succession. Therefore, a
dictator’s job is simply to exert the right amount of repression and acquire the right amount of loyalty to maximize his utility objective of power or consumption. However, it is not always the case that dictators have absolute power to implement repression and loyalty. A dictator’s power may be constrained initially because of ideological differences among political factions, thus preventing the dictator from applying repression. The dictator may first have to align factional political interests before solving the optimization problem of the dictatorship model.

The purpose of the dictator in aligning different interests among political factions is to secure and stabilize his office. The dictator would not be able to maximize his power or consumption before ensuring that his office is stable. Compare the dictator to a leader in a democratic system who is running for office through a voting process. Before the democratic leader has any ability to implement his policies, he needs to establish his credentials and attract enough votes to run for office. Once in office, he will then be able to implement his political agendas.

Political agendas can generally be viewed as benefiting one group at the expense of another group. Therefore, the democratic leader’s political agenda would result in the repression of one group in terms of reducing that group’s economic value, rather than in their physical repression. To achieve this agenda, the democratic leader has to acquire enough support from the other group benefiting from the political agenda. Gaining support in this democratic system is similar to a dictator acquiring loyalty from one group in order to apply repression to another group.
If the above concept is applied to the dictatorial leaders of China, they also have to engage in this two-stage process of establishing political credentials, and then implementing political agendas. The difference is that Chinese dictators do not establish their credentials by popular vote; instead, they have to go through an implicit voting process within the Communist Party of China (CPC). They have to secure enough support, and get rid of opposition within the CPC. Their ability to maximize power comes into play only after they have secured their offices.

Once Chinese dictatorial leaders have secured their offices and ensured their stabilities, Wintrobe’s general model of dictatorship can then be applied to comprehend the motivations of the Chinese dictatorial leaders in adopting specific political and economic policies. Based on this model, it is possible to analyze political and economic conditions that trigger the changing levels of repression and loyalty adopted by the Chinese dictatorial leaders in order to optimize their utility objective of power.

Using the approaches above, what is needed is an in-depth analysis of the Chinese dictatorial leaders, in order to understand their ideological formations and the changing nature of these leaders. More specifically, it is imperative to compare and contrast Mao Zedong and Deng Xiaoping due to their extremely polarized ideologies. Mao can be viewed as a merciless dictator while Deng can be viewed as a benevolent dictator in contrast to Mao. Jiang Zemin and Hu Jintao are less relevant in this analysis because Jiang simply followed Deng’s footsteps while Hu adopts a hybrid approach of dictatorship, falling somewhere between Mao’s and Deng’s ideologies.
4. Mao Zedong – Political Ideology Formation

Prior to the examination of Mao as a dictator and how he was able to maximize power through the use of repression and loyalty, it is crucial to understand Mao through the lens of historical China. Since Mao was brought up in the transitional period before and after the downfall of the Qing Dynasty, the last imperial dynasty of China, Mao’s ideological formation must be deeply influenced by Chinese imperial thoughts. That Mao was influenced by the imperial thoughts was made evident through his action of burning the Confucian books, which proved that he was eager to break away from the outdated imperial tradition.

Mao was born in 1893, a period of chaos and turbulence caused by the weakening of the Qing Dynasty, and by the Western invasion. At that time, Qing’s economic and military strength was no match compared to the major western powers. Following the collapse of the Qing Dynasty in 1912, and the Chinese Republic’s failure to restore China, the sense of urgency among the Chinese intellectuals evoked the New Culture Movement (1915 – 1925). This movement was aimed at ridding China of the Confucian culture, and the feudal tradition, and at creating a new culture based on western values of equality and democracy. The demand for cultural change led to the May Fourth Movement in 1919 with student demonstrations in Beijing. Mao was one of the younger followers in this movement.

During the New Culture Movement, Western parliamentary democracy and Communism became two possible alternatives to Chinese feudalism and Confucian culture. The Communist ideal was accepted because the Communist Bolsheviks led by Lenin succeeded in the October Revolution in Russia in November 1917. This period of
social and political ideological revolution led to the formation of the CPC in 1920, and Mao was a participant in this process. This social trend and consensus for a new culture was Mao’s initial experience with revolutions, and became the foundation for “Mao Zedong Thought.”

The influence of the New Culture Movement is reflected in Mao’s writing “On New Democracy” in January 1940. In his writing, Mao addressed the issue of building a new China. Mao stated that “The goal of all these revolutions is to build a new society and a new state for the Chinese nation…..not only do we want to change a China that is politically oppressed and economically exploited….., we also want to change the China which is being kept ignorant and backward under the sway of the old culture into an enlightened and progressive China under the sway of a new culture.” (Schram and Hodes, 1969)

Social and political conditions in the late Qing Dynasty and the Chinese Republic period also had a great impact on Mao’s ideological formation. At the time of the downfall of the Qing Dynasty, political, military, and economic powers were divided among the wealthy Chinese warlords, Yuan Shikai, commander of the Beiyang fleets, and the KMT. After the formation of the CPC, the CPC became another force in this scrambled power struggle. Mao’s adaptation of the Communist economic central planning and the commune system could be the result of his political and military experience during this period of highly divided power struggle. Mao’s experience may also have reinforced his thought on building a new Chinese culture.
The Confucian thought used by Chinese emperors over the past several centuries was not feasible to bring China’s social and political condition back on track. Confucianism may have even caused the weakening of the Qing Dynasty. The essence of Confucianism is humanism, which is stressed by ren, yi, and li. Ren is interpreted as altruism and humaneness toward individuals within a community; yi is interpreted as the righteousness to do good; and li is interpreted as the norms and propriety that a person should follow within a community. (Craig, 1998) The ideal of humanism in Confucianism was also applied to governance. To govern others, the King must first govern himself. An interpretation of this idea, similar to the Taoist concept of wu wei, is that the less the King does, the more gets done.

When Mao came into power and became the Chairman of the People’s Republic of China, he rapidly adopted the Soviet-style Communism, with economic central planning and collective economic production. In addition, Mao mobilized the masses to achieve his continuous revolutions. People who did not share his vision were deemed “counter-revolutionary.” Maoism or Mao Zedong Thought was derived from a combination of the Marxist and Leninist communist theories and his view on continuous revolutions to bring about a new Chinese culture.

Mao’s attraction toward the Communist ideology and continuous revolutions can be analyzed from two different perspectives, both of which reinforced Mao’s Communist ideology. First, the different alternatives of thoughts that existed in China after the downfall of the Qing Dynasty will be examined, and then, the forces and conditions which facilitated Mao’s decision to adopt Communism over the other alternatives will be
determined. Second, the historical influence on Mao which led him to adopt Communism will be examined.

During the New Culture Movement, people were eager to seek out alternative models to replace China’s feudalistic and Confucianist culture. Parliamentary democracy from the West and Communism from the Soviet Union were alternative models to Confucianism. The Western revolutions took place in the 17th and 18th century, with the formation of the bourgeoisie or capitalist social class. The term bourgeoisie was defined in Marxism as the social class in a capitalist society that owns the means of production such as land, factories, capital, and other economic resources. (Marx and Engels, 1969)

Mao’s rejection of Western bourgeoisie thought may be the consequence of his experience with the Western invasion of China and his influence with the Chinese political culture. Even though Mao despised China’s feudalistic tradition, he didn’t believe that the Chinese bourgeoisie had the strength to succeed. At the same time, he also believed that by adopting the Western bourgeois culture, China would become vulnerable to the enslaving ideology of Western imperialism. Mao asserted his view that “Chinese bourgeoisie lacked strength and the world had already entered the era of imperialism, this bourgeois ideology was only able to last out a few rounds and was beaten back by the reactionary alliance of the enslaving ideology of foreign imperialism and the ‘back to the ancient’ ideology of Chinese feudalism.” (Schram and Hodes, 1969)

The above reasons also explain why Mao became obsessed with Communism and continuous revolutions. The Bourgeois social class and individual ownership of production would not be compatible with China’s social and political condition at that
time. Since the feudal culture had already caused social chaos and power separation, the ideal behind the bourgeoisie could potentially make China’s social and political condition worse, and could lead to even greater power separation or greater power distribution to the warlords.

On the contrary, common ownership as a mean of production, an ideal promoted in Communism, made more sense for Mao. Adopting the Communist ideal would serve to achieve Mao’s objective of unifying and building a new China. It would provide Mao with the means necessary to curb the power of the Chinese warlords and to reunite the Chinese population under a common goal, which was to build a new Chinese national culture. In fact, creating a common ownership was one of the first institutional changes Mao had implemented.

Through a full-scale land reform during the Chinese civil war (1945 – 1949), Mao confiscated massive land owned by wealthy landlords and redistributed them to the peasant class. Mao’s application of Communism, given China’s situation, was distinct from the theory of urban revolution through factory workers in Marxism-Leninism. Marx even dismissed the role of peasant class in revolutions. (Cheek, 2002)

China’s social and political split in the early 1900s, followed by autocratic political control, was not without precedent. In fact, China had experienced similar scenarios on many occasions throughout the imperial era. The most identical of these occasions was the period from the Eastern Zhou Dynasty (770 – 221 BC) to the Qin Dynasty (221 – 206 BC). The Eastern Zhou Dynasty was similar to the late Qing Dynasty, with a weak central state and numerous smaller feudal states controlled by
hereditary lords. This unstable social and political structure led to constant war among hereditary lords, each with the ambition to dominate others. Through military conquests, seven powerful states emerged, and one of them was the Qin State.

In 230 BC, King Ying Zheng of Qin declared war against the six other states. Within nine years, Ying Zheng was able to unify China by defeating the six states. He assumed the name Qin Shi Huangdi or the Emperor of Qin. (World History: Volume I: To 1800, 2006) Qin Shi Huang was the first emperor to adopt Legalism into the central administration. The essential principle of Legalism was to obey the rule by law, and the ruler was granted authority.

Since the loose central control of the Eastern Zhou Dynasty led to constant warfare, Qin Shi Huang, after China’s unification, believed in the supremacy of the central government over individual autonomy. Therefore, the adoption of Legalism provided Qin Shi Huang with absolute power over the central administration and the population. Anyone disobeying him or the law was severely punished.

Chinese scholars have often compared Mao to Qin Shi Huang because of similarities in their tyrannical rule over China. More significantly, both had engaged in the destruction of the Confucian culture by burning all intellectual books and killing scholars. Their ruthless conduct used to unify China was motivated by a similar social and political condition at the time prior to seizing power.

The social and political condition of the late Qing Dynasty before Mao came into power was identical to the condition of the Eastern Zhou Dynasty before Qin Shi Huang came into power. Both Mao and Qin Shi Huang experienced constant warfare, rebellions,
and power struggle among the warlords. Henry Kissenger, the former American Secretary of State and Nobel Peace Prize laureate, pointed out that: “It was no accident that the Chinese ruler whom Mao most admired was the founding Emperor Qin Shihuang, who ended the Period of the Warring States by triumphing over all other rivals and unifying them into a single polity in 221 B.C.” (Kissinger, 2011)

Given the identical social and political condition, both Mao and Qin Shi Huang shared a similar taste in ideology and distaste for the Confucian culture. Mao even compared himself to Qin Shi Huang in his suppression against intellectuals when he commented in his speech that “[Qin Shi Huang] buried 460 scholars alive; we have buried forty-six thousand scholars alive….. You [intellectuals] revile us for being Qin Shi Huangs. You are wrong. We have surpassed Qin Shi Huang a hundredfold.” (Mao, 1978)

Along the same line, Mao’s adoption of Communism can also be compared with Qin Shi Huang’s adoption of Legalism. Legalism believes in severe punishment of both the powerful and the weak, and that the law should be equally applied. The Legalist system provided Qin Shi Huang with the capacity to weaken the power of the feudal lords, and redistribute power into thirty-six administrative provinces. Qin Shi Huang even standardized the Chinese writing system, possibly for the purpose of transforming China into a highly integrated and unified country.

It is not hard to see the similar characteristics between Legalism and Communism. The concept of common ownership and central planning under Communism also provided Mao with the capacity to weaken the power of the warlords in the early 1900s through land confiscation. Common ownership and a classless society
restrain any individuals from becoming more powerful than others. If all people in the society are equal economically and politically, then the central government becomes the only entity with power. Like Qin Shi Huang, Mao also turned China into a highly integrated and unified country through the people’s commune system, even though it was against individual self-interest.

In conclusion, based on the analysis above, Mao’s ideology and his adoption of Communism were formulated not only by his desire to accumulate power as a dictator; but also, Mao’s ideology was deeply influenced by the Chinese imperial tradition and his experience during the period of the weakened Qing Dynasty. With this understanding, the next logical step is to analyze Mao from the perspective of Wintrobe’s model of dictatorship after Mao came into power as Chairman. Using Wintrobe’s model of dictatorship, Mao’s behavioral and political changes as a dictator, given Mao’s utility maximization objective, his constraints, and his desire for repression and acquiring loyalty will be examined.

5. Mao Zedong – Transformation from a Totalitarian to a Tyrant Dictator

After thoroughly examining Mao’s ideological formation before he came into power, the next logical step is to examine Mao as a dictator after he came into power. Out of the four types of dictators stated by Wintrobe, Mao was considered a totalitarian before the Cultural Revolution. Mao fits into this category because he was able to implement a high level of repression while maintaining a high level of loyalty in the population. Why did Mao behave, initially, like a totalitarian rather than a tyrant, a tinpot, or a timocrat?
As a totalitarian, Mao’s utility objective of maximizing power was driven by his ideology. Mao’s abomination of the Confucian culture and feudalism pushed him to follow the path of revolutions. He believed that the only way to create a new China was through continuous revolutions. Therefore, maximizing personal power was essential for Mao to achieve continuous revolutions. The utility objective of maximizing personal consumption used by tinpot and timocrat dictators was incompatible with Mao’s ideology.

The nature of revolutions is to secure a strong loyalty base from one group of people in the society, which can then be used to repress another group. Mao’s ideal on continuous revolutions required him to secure a strong loyalty base; otherwise, he would not have enough support for revolutions. A tyrant dictator with a low loyalty base also did not suit Mao. Therefore, only totalitarian dictatorship with high levels of repression and loyalty served Mao’s purpose of continuous revolutions.

Mao’s categorization as a totalitarian can also be supported by the political condition prior to the unification of China. During the period from the 1920s to the 1940s, the CPC and the KMT were fighting each other for the control of China. In addition, there was the complication of the Japanese invasion. The military campaign led by Chiang Kai-shek, called the Northern Expedition (1936 to 1938), was aimed to wipe out the warlords and the CPC. Mao, with his army, was engaged in the battle with the KMT, and, later on, united with the KMT to fight the Japanese army.

This is a period of constant war and running for both conquest and survival. Tinpot and timocrat, with their consumption maximizing behavior, did not suit Mao at
the time. Tyrant dictatorship was also out of the question because fighting a war requires strong military and political support in order to win. Therefore, the only possible model Mao was able to use was the totalitarian dictatorship. This general understanding of why Mao behaved as a totalitarian initially, affords a basis for analyzing Mao’s initial use of repression and loyalty: how political, economic, and social conditions affected Mao to change the levels of repression and loyalty used during different periods of his political career; and the factors that transformed Mao from a totalitarian to a tyrant during the Cultural Revolution.

When Mao first came into power as a totalitarian, his power maximizing motive required him to implement highly repressive policies and to acquire a strong loyalty base. Before Mao was capable of implementing his ideology, he had to first secure and stabilize his power base. Therefore, Mao needed to take incremental steps in making political reforms. The Agrarian Reform Law of 1950 was the first incremental step enacted by Mao as a continuation of the earlier land reform enacted by the CPC. The land reform was aimed at confiscating cultivated land from rich landlords and redistributing them to the peasants. This policy helped Mao to win over the support of the peasant class at the cost of rich landlords. By 1952, about 43 percent of the cultivated land was redistributed. This repressive act resulted in the death of rich landlords, from 800,000 to two million. (Strauss, 2002)

Mao’s repression was aimed not only at rich landlords, he also targeted corrupted cadres and wealthy capitalists. The Three-anti and Five-anti campaigns were launched in 1951 and 1952. The three antis were anti-corruption, anti-waste, and anti-bureaucracy
targeted at counter-revolutionaries within the CPC. (Spence, 1991) The five antis were anti-bribery, anti-theft of state property, anti-tax evasion, anti-cheating on government contracts, and anti-stealing state economic information. Wealthy capitalists were publicly attacked for defrauding the public and committing economic crimes. Those capitalists who were under attack were forced to accept state control of their enterprises. The Three-anti and Five-anti campaigns contributed to the death of 500,000 to 800,000 people. (Roberts, 2006)

Among the initial reforms to attract support, the Marriage Law, which permitted women to freely choose their partners, was enacted in 1950 to replace the traditional feudal marriage system. The education system was also expanded to provide education to millions of adults and additional education to teachers. These initial reforms greatly strengthened Mao’s image as a great leader. This strong loyalty base provided Mao the capacity to implement central economic planning in the near future.

The second stage of reform initiated by Mao took place from 1953 to 1956 with the first Five-Year Plan, aimed at building a Soviet type of socialism in China. To build socialism, the means of production must be collectively owned and controlled cooperatively. (wspus.org, 2011) Building socialism in China required Mao to eliminate the private market economy, which contributed to more than two-thirds of China’s production. (Lardy, 1987) Mao’s ambition could be achieved only by intensifying the use of repression.

As the initial step, the state took control over prices and purchases of agricultural goods, followed by the collectivization of agricultural production. Mao believed that a
centrally planned agricultural production would speed up the development of the industrial sector. A strong industrial sector would enhance China’s economic power. The collectivization process started with the formation of the “Mutual Aid Teams” to encourage farmers to help each other on the fields. Second, the “Agricultural Producers’ Cooperatives” were formed and farmers were forced to surrender their land, tools, and animals to the collective. (Tanner, 2010) In 1956, ninety-five percent of farmers were living under collectives. (Lardy 1987)

Agricultural collectivization faced resistance from farmers who were not willing to surrender their land and materials. This resistance also generated internal objections among party leaders in the CPC. However, Mao was determined that agricultural collectivization would prevent the re-emergence of rich landlords. In order to effectively repress the farmers to ensure the success of the collectives, Mao relied on the support of provincial officials who were eager to align with Mao.

The first Five-Year Plan succeeded with the development of the industrial sector and also led to high economic growth. In 1956, investments in capital construction totaled 14.7 billion yuan. Thousands of industrial enterprises were constructed, including iron and steel manufacturing, coal mining, cement production, electricity generation, and machine building. From 1952 to 1957, national income grew at an annual rate of 8.9 percent and industrial production grew at an annual rate of 19 percent. (Lardy, 1987)

As predicted in Wintrobe’s model of dictatorship, high economic performance under totalitarian dictators would lead to a higher level of repression. (Wintrobe, 1990 & 1998) This is exactly the mindset Mao had at the end of the first Five-Year Plan. At the
Supreme State Conference in January 1958, Mao stated in his speech: “In making revolution one must strike while the iron is hot – one revolution must follow another, the revolution must continually advance.” (Meisner, 1977) Soon after Mao’s speech, in 1958, the Great Leap Forward was implemented.

The purpose of the Great Leap Forward was to make a more radical change in China’s economy in order to speed up economic development. The slogans to promote the Great Leap Forward were “produce more, better, faster,” and “overtake England in fifteen years and America in twenty years.” (Meisner, 1977) Farmers that were forced into the collectives during the first Five-Year Plan were now restructured into the people’s communes.

The commune system was considered a more repressive form of the collectives. Communal kitchens, collective day care, elementary education, and health care were all developed under the commune system. Agricultural land that was not part of the collectives was now organized under the communes. The “backyard steel furnaces” were also built in each commune for steel production. Increased repression through the commune system and forced recruitment of grain production triggered deterioration in the economy. Combined with famine from 1960 to 1962, the Great Leap Forward caused the death of about thirty to forty million Chinese people. (Smil, 1999)

The disastrous effect of the Great Leap Forward forced Mao to step down as the Chairman of China. He was replaced by Liu Shaoqi as the President of China in April 1959. However, Mao was still able to keep his chairmanship in the CPC. Even though Mao’s power was reduced, it did not stop his desire for continuous revolutions.
Since Mao’s ultimate objective was to create a new China through continuous revolutions, he initially relied on the communist ideal and central economic planning to accomplish this objective. Mao believed that communism provided him with the necessary tools to attack counter-revolutionaries and the bourgeoisie. In reality, communism worked against Mao, which cost him his chairmanship of China.

When economic development failed to serve his objective of revolutions, Mao began to look elsewhere. Rather than indirectly attack the counter-revolutionaries and the bourgeoisie by weakening their economic power, Mao attacked them directly by using political purges through the Cultural Revolution. On another dimension, the name “Cultural Revolution” reflected Mao’s core desire to abandon the Confucian and traditional Chinese feudal culture. He may have thought that the traditional Chinese culture was the biggest barrier to achieving a new China. Therefore, attacking the Chinese culture was working on the root of China’s problem.

The Cultural Revolution was launched by Mao in 1966, and was aimed at removing his political opponents, the bourgeoisie, and the old Chinese culture. The revolution began when Mao removed from office Yang Shangkun, the director of the CPC’s General Office, Luo Ruiqing, the Chief of Staff of People’s Liberation Army, Peng Zhen, the Beijing Mayor, and Lu Dingyi, the director of Propaganda.

More significantly, millions of students were organized into Red Guard groups and prepared to attack the liberal bourgeoisie in the society. On August 18th, 1966, millions of Red Guards gathered at Tiananmen Square to meet with Mao to show their support for the revolution. In addition to attacking the bourgeoisie, Mao also directed the
Red Guards to destroy the “Four Olds,” including old customs, culture, habits, and ideas. Old books and arts were destroyed, streets were renamed, and many famous heritage sites were also destroyed. Politicians and intellectuals who were deemed counter-revolutionary also came under attack. Politicians were denounced and intellectuals were sent out to villages to do manual labor (Meisner, 1977) From a recent estimate by Andrew Walder and Yang Su, the death toll from the Cultural Revolution was between 750,000 to 1.5 million. (Walder and Su, 2003) The death toll from starvation was 30 million.

According to Wintrobe’s model of dictatorship, three implications can be drawn about tyrant dictators. Tyrant dictators use violence to maintain their power; they do not care about the material interests of their people; and they derive satisfaction from restraining their subjects. (Wintrobe, 1990 & 1998) Given these implications, Mao, during the Cultural Revolution, fits perfectly as a tyrant dictator.

The Cultural Revolution was one of the most violent revolutions in world history, and Mao derived satisfaction from it. Mao’s desire to kill was evident when he made this remark during the Cultural Revolution: “This man Hitler was even more ferocious. The more ferocious the better, don’t you think? The more people you kill, the more revolutionary you are.” (MacFarquhar and Schoenhals, 2006) During this period, Mao’s pure focus was on attacking the counter-revolutionaries. He cared less about economic development.

After Mao’s death in 1976, the effect of the Cultural Revolution was eventually ended. Mao’s obsession with building a new China through continuous revolutions turned him from the “Great Leader Chairman Mao” into one of the most violent tyrant dictators
in world history. Mao’s death signified the downfall of communist central economic planning and was followed by a new era of leadership led by Deng Xiaoping. This new era contributed to China’s rapid economic development and modernization.

6. Conclusion
Mao’s behavior as a dictator was driven not only by his desire to accumulate power through repression and loyalty, but, more importantly, was driven by his ideology of building a new China through continuous revolution. When economic means failed to achieve his ideology, Mao was trapped in the idea of continuous revolutions to build a new China. As a result, Mao transformed himself from a totalitarian into a tyrant, and initiated the Cultural Revolution. In a way, Mao’s behavior as a dictator was no different from any of the other Chinese emperors. The unique Chinese history and culture that Mao was eager to break away from eventually became his own kryptonite, and prevented him from building a modernized China.

7. Deng Xiaoping – Identifying His Ideological Puzzle
When Deng Xiaoping came into power after Mao’s death, he initiated a series of economic reforms which contributed to China’s rapid economic growth over the past three decades. Deng’s bold approach in implementing pro-market institutions under China’s communist system directly contradicted the Marxist-Leninist ideology of public ownership and central economic planning. Deng’s pro-market economic institutions, such as the contract-responsibility system, the profit-retention program, the dual-track system, and fiscal decentralization paved the way for China’s modern market economy of today. As a communist dictatorial leader, why would Deng choose the path of market oriented
reforms rather than following Mao’s central economic planning? The answer to this simple question requires in-depth analysis of Deng’s ideology.

Unlike the Mao Zedong Thought of creating a new China through continuous revolutions to abandon China’s feudalism and Confucianism, Deng Xiaoping Theory does not have an obvious or clear central political ideology. Deng’s theory does not reject Marxism or Mao Zedong Thought. As State former American Secretary of State and Nobel Peace Prize laureate Henry Kissinger puts it: “[Deng] articulated no grand philosophy; unlike Mao, he made no sweeping claims about the Chinese people’s unique destiny.” (Kissinger, 2011)

In contrast to Mao, rather than pursuing a core political ideology, Deng’s goal was on the Four Modernizations, including agriculture, industry, national defense, science and technology. To advance Four Modernizations in China while preventing resistance from left-wing members of the CPC, Deng developed the “Four Cardinal Principles.”

The four principles are: upholding the socialist path, upholding the people’s democratic dictatorship, upholding the leadership of the CPC, and upholding Marxist-Leninist-Mao Zedong thought. Because of their abstractness, the meaning of the four principles is open to interpretation. However, based on the four cardinal principles, Deng was able to transform China from a centralized economy to a market economy while preserving the ideology of the CPC. The influence of Deng’s policies on China’s economic development was termed “socialism with Chinese characteristics.”
Even though Deng Xiaoping Theory does not provide a direct trace to the reasons why Deng pushed for pro-market reforms, many of his famous phrases indirectly hint at the answer. Deng liked to use the phrases: “seek truth from facts,” “do not care if the cat is black or white, what matters is it catches mice,” “poverty is not socialism, to be rich is glorious,” and “let some people get rich first.” These famous phrases, spoken by Deng on many different occasions, represent his sense of pragmatism.

Pragmatism, without any particular hardline political ideology, could possibly be Deng’s core political value. Pragmatism is reflected in Deng’s economic reforms. Deng did not believe that market economy contradicts socialism, even though a Marxist-Leninist state utilizes a centrally planned economy to achieve its means. (Andrain, 1994) Deng’s justification for market economy was: “Planning and market forces are not the essential difference between socialism and capitalism. A planned economy is not the definition of socialism, because there is planning under capitalism; the market economy happens under socialism, too. Planning and market forces are both ways of controlling economic activity.” (Gittings, 2005)

Deng’s pragmatism and flexibility in adopting capitalist economic value was also reflected in his quotes: “We mustn’t fear to adopt the advanced management methods applied in capitalist countries (...) The very essence of socialism is the liberation and development of the productive systems (...) Socialism and market economy are not incompatible (...).” (Caeiro, 2004)

If Deng’s core value was truly based on pragmatism, then it should be evident not only during the period of his market-oriented, economic reforms, but throughout his
political career as well. In fact, Deng’s political pragmatism can be traced back to the Long March (October 1934 to October 1935), the period when he became an important figure of the CPC.

When Deng joined the Long March at age 30, he was the chief secretary of the Central Committee of the CPC. Deng then left the party and became the chief of the Propaganda Department in the First Army Corps. During the Long March, Deng attended the Zunyi Conference in January 1935. That meeting was basically a power struggle for leadership between Bo Gu and Mao Zedong, with Mao coming out as the winner and taking over military command. That conference was not only one of the determining factors for Mao to become the Chairman of China in 1949, but it also had a long lasting impact on Deng.

At that time, Deng was serving as chief of the Propaganda Department. His main assignment was to run a song-and-dance troupe of mostly women. So Deng was searching eagerly for political support from the higher ranking members in the CPC. Mao’s greatly enhanced status after the Zunyi Conference was the determining factor for Deng to become Mao’s loyal supporter for many years to come. Before meeting with Mao, Deng’s idol for many years had been Zhou Enlai. But Zhou was under attack at the Zunyi Conference, and his wrecked personality was no comparison against Mao’s charismatic personality. (Yang, 1998)

This particular event revealed Deng’s natural sense of pragmatism and flexibility in politics. Deng’s behavior at the time was not motivated by any particular ideology when choosing his political alliance. Rather, Deng’s motivation was based on who was
more likely to become the next leader. This sense of pragmatism drove Deng’s support away from Zhou to Mao. Fortunately, Mao also liked Deng, and their relationship became closer when Deng followed Mao in the Eastern Expedition in March 1936.

When Deng became a trustworthy member of Mao’s faction, Deng quickly rose up the political ladder. During the Second Sino-Japanese War, Deng was promoted to Political Commissar of the 129th Division of the Eighth Route Army, and was in charge of important battles with Commander Liu Bocheng. After the Second Sino-Japanese War, the Chinese Civil War resumed, and Deng was again in charge of key battles and was promoted as the Political Commissar of the Shanxi-Hebei-Shandong-Henan Military Command.

After the establishment of the People’s Republic of China, Deng was promoted by Mao to be the executive Vice-Premier of the State Council, and Vice-Chairman of the Financial and Economic Commission in 1952. In just four years, in 1956, Deng entered the central organ of the CPC. Deng was elected a member of the Standing Committee of the Political Bureau and General Secretary of the Central Committee.

All these promotions contributed to Deng’s loyal support of Mao, which also included ideological support. During the agrarian reform and counter-revolutionary movements in 1950, Deng gave a speech at a conference to Chongqing party representatives. “It is very dangerous for some of our comrades to think that the revolution is now completed and we can just take a comfortable nap and be conceited and enjoy our personal life…..As communists, we must regard our party’s work, not just personal material enjoyment…..It must be made crystal clear that our own material
conditions cannot surpass the level of the general society.” (Deng, 1989) Deng’s loyal support of Mao on the ideological front clearly contradicted his market-oriented reforms in the 1980s. However, this again reflected Deng’s political flexibility in order to achieve his long-term goals.

Deng continued to support Mao until the end of the Great Leap Forward. When Mao’s image and power were dramatically reduced from the disastrous economic outcome as a result of the Great Leap Forward, Deng took a step back in his relationship with Mao and realigned himself with Liu Shaoqi, who replaced Mao as the Chairman of China in 1959. Mao, during the Cultural Revolution, spoke of his relationship with Deng at the end of the Great Leap Forward: “From 1959 up to the present time, Deng has never come to see me about anything. Deng is a deaf mute, but whenever he was at a conference, he always chose to sit in a spot far from me. He respected me but kept away from me, treating me like a dead ancestor.” (Mao, 1978)

Once Deng became aloof toward Mao, he immediately readjusted his ideological position. During a conference of the Communist Youth League in July, 1962, Deng said: “Speaking about which is the best system of production, I would support whatever type can relatively easily and rapidly restored and increase agricultural output, and whatever type the masses are willing to implement should be adopted. If it is not yet legal, then it should be legalized. Yellow or white, a cat that catches mice is a good cat.” (Deng, 1989)

In 1966, Mao initiated a power struggle through the Cultural Revolution to regain his power. Mao succeeded and took down Liu Shaoqi and Deng. Liu and Deng were put on trial in Zhongnanhai on August 5, 1967. The following excerpt was published:
RED GUARD: Aren’t you a capitalist roader in power within the party?
LIU: No, I am not, though I did make some mistakes while working for the party.
DENG: Yes, I am.
RED GUARD: Do you oppose our great leader Chairman Mao?
LIU: No, I don’t.
DENG: No, I don’t. But I opposed Mao Zedong thought.
RED GUARD: Why did you trust and support Peng Zhen?
LIU: Because he would never deceive me.
Deng: Because he had deceived me. (Zhao, 1977)

Liu was tortured by the Red Guards for his response at the trial, whereas Deng was left un-tortured because of his acute sense to quickly admit his mistakes and change political ground. Deng used the same political strategy when he asked Mao to bring him back to Beijing to resume his positions in the CPC after the Cultural Revolution. Even though Deng was purged, he would quickly admit his mistakes and ask for sympathy.

8. Deng’s Succession and Subsequent Behavior
Deng’s masterful application of his pragmatic political ideology helped him to avoid or minimize political conflicts while drawing support in the CPC. Deng’s strategic approach to climbing the political ladder in the CPC allowed him to assume de facto leadership in China in 1978.

Before Mao’s death, he named Hua Guofeng as his successor in the CPC. Months after Mao’s death, Hua Guofeng succeeded Mao as the Chairman of the CPC and the Chairman of the Central Military Commission. Deng was not the choice of candidate
because he sided with Liu Shaoqi after the Great Leap Forward, which conflicted with Mao’s economic and political ideology.

Before Hua assumed power in 1976, Deng was purged again by Mao before Mao’s death. This time, Deng was purged for not openly supporting Mao’s Cultural Revolution. After Hua assumed power, Deng was still under purge, so he was in no position to compete with Hua. At a disadvantaged position, Deng first praised his enemy through a letter to Hua. In the letter, Deng wrote: “Comrade Hua Guofeng is the most appropriate successor to Chairman Mao. His youth guarantees that the proletarian leadership will remain stable for at least fifteen or twenty years.” (Deng, 1989)

This move helped Deng to maneuver himself slowly to the inside of the CPC under Hua’s radar. During the Third Plenum of the Tenth Congress held in Beijing in July 1977, Deng’s former positions were restored, including the deputy chairman of the Party Center, first deputy premier of the State Council, deputy chairman of the Military Council, and chief of staff of the People’s Liberation Army. Soon after Deng’s power was restored, Deng launched an attack on Hua.

Deng’s attack began by using the political movement “Beijing Spring” to openly criticize the Cultural Revolution. This move strengthened his support among the public, while making political alliances with other party members who were purged under Mao.

Hua, on the other hand, continued to follow Mao’s political and economic ideology. In 1977, Hua promoted the policy of “Two Whatevers” under the title “Study the Documents Well and Grasp the Key Link” in the February 7th edition of the People’s Daily. The Two Whatevers stated that “We will resolutely uphold whatever policy
decisions Chairman Mao made, and unswervingly follow whatever instructions Chairman Mao gave.” (Su, 2011) Even though Hua also criticized the Cultural Revolution, he put the blame on the Gang of Four.

At the time when the Two Whatevers statement was published, the Cultural Revolution had just ended. Therefore, the statement was not very popular among the party members. It made more sense to reform China’s institutions rather than to return to Mao’s failed policies. Deng attacked the Two Whatevers and criticized Hua’s politically backward ideology. Gradually, Hua and his political faction lost its power against Deng.

In 1981, Hua was eventually demoted from the party leadership, and was replaced by Hu Yaobang as the Chairman of the CPC. After Deng took out Hua, Deng became the de facto leader of China and initialed a series of market-oriented economic reforms. Deng never assumed the title of Chairmanship, probably for the same pragmatic, ideological reason that drove Deng all the way to the top of China’s political pyramid.

After Deng secured his power in the CPC, he applied the same pragmatic, ideological approach to China’s market-oriented economic reforms. Deng did not care if a market economy was incompatible, from an ideological perspective, with socialism, as long as it facilitated the advancement of the Four Modernizations to strengthen China economic power. Deng’s economic reforms included the profit-retention program, family-responsibility system, the dual-track system, fiscal decentralization, and the development of the special economic zones.

Given the political and economic conditions at the time, Deng’s pragmatic political ideology was an inevitable factor in contributing to his success as a political
leader and as a mastermind behind China’s market-oriented economic reforms. This inevitable factor can be traced back in time to the transitional period from the Qin Dynasty to the Han Dynasty. If Mao is to be compared to Qin Shi Huangdi for similarities in their harsh tyrannical rule and their ideological conflict with feudalism and Confucianism, then Deng can be compared to the first emperor of Han, Gaozu.

Given the harsh political and economic condition under tyrant dictators, both Gaozu and Deng can be said to have risen into power with pragmatic political value. Both men did not follow the path of their tyrant predecessors. Instead, they adjusted their political value to suit the political and economic condition of their times. Deng restructured China’s agricultural system in order to promote growth, while Gaozu reduced land tax on agricultural production to promote growth.

Clearly, then, Gaozu and Deng shared the same sense of pragmatism. Gaozu was just as pragmatic as Deng if not more so. Initially, Gaozu rejected Confucianism because he disliked reading. But once he was enlightened by the scholar Lu Gu on Confucian thought, Gaozu quickly abandoned the harsh, Legalist political system and adopted Confucianism.

From this comparison of Gaozu and Deng, it is no coincidence that pragmatic political ideology thrived after harsh tyrannical rule. It might have been the best alternative that was socially acceptable to tyrant dictatorship. For both leaders, pragmatic, political ideology turned China into a dominant, economic and political force among their neighboring countries.
Deng’s pragmatic ideology, as well as influences from his childhood, were factors that contributed to his adoption of pro-market economic reforms. Deng was brought up by his father, Deng Wenming, the wealthiest landlord in the village of Paifang. Deng’s family owned twenty acres of arable land, one-third of which was managed by Deng Wenming, and the other two-thirds were rented out to tenant farmers. During his childhood, Deng’s education in Chongqing, and then in France was attributed to his father’s financial wealth. Without this foreign education opportunity, Deng may not have had the opportunity to form a valuable, political network with important members of the CPC. Therefore, Deng personally benefited from China’s landlord system.

Also, when he was very young, because his father was able to afford it, Deng received private tutoring in Confucianism. So, at a very young age, Deng was soaked in the Confucian tradition. Whether Deng accepted China’s traditional feudalism and Confucianism is a question mark, but at least he didn’t object to it, personally. In contrast to Mao, Deng did not share the same hatred for feudalism and rich landlords. Deng attacked rich landlords in the 1950s simply because he was following Mao’s order. So his conduct was the result of a pragmatic political calculation.

When he came to power in 1978, Deng’s very first economic reform was the family-responsibility system, essentially a reform to China’s agricultural land ownership. It was used to provide individual incentives for agricultural production by allowing farmers to contract arable land from the state. Deng’s use of this property rights structure model was identical to the land management system of his father. He would not have initiated agricultural ownership reform if he really hated rich landlords.
Deng’s sense of pragmatism kept him away from the extreme leftist or extreme rightist ideology in the CPC. This was illustrated in 1980, when Deng took down Hua Guofeng, the diehard follower of Mao’s central economic planning, and replaced him with reformist, Zhao Ziyang, in order to reduce the left wing’s resistance to market-oriented reforms. When economic reforms caused social and political problems in the late 1980s, Deng dismissed Zhao Ziyang, which led to the Tiananmen Square shooting incident of June 4th, 1989. Even after the incident, Deng continued to promote economic reforms during his Southern tour.

The June 4th, 1989 incident was a result of the buildup of economic, social, and political issues that arose from Deng’s economic reforms. The event was triggered by the death of the CPC’s General Secretary, Hu Yaobang. The incident started out as a mass mourning for the death of Hu Yaobang. One hundred thousand people gathered at Tiananmen Square to show their sympathy to Hu because he was purged for his support of political liberalization. (Pan, 2008) This gathering led to a demonstration in Beijing by college students, demanding faster economic reforms and greater political freedom. (Nathan, 2010)

When things were out of control, Deng turned himself into a tyrant by using violence to suppress the protest. Deng ordered Premier Li Peng to declare Martial Law on May 20th, 1989. On June 4th, the People’s Liberation Army was sent with tanks to the streets near Tiananmen Square to drive away the protestors. As the protestors resisted, weapons were fired which resulted in the death of thousands. After this incident, Deng ordered the arrests of protestors, student leaders, and several senior officials within the
CPC such as the CPC’s General Secretary Zhao Ziyang. Deng also banned foreign press in China and strictly controlled domestic media coverage. (Miles, 1997)

Since 1978, Deng had acted as a benevolent, totalitarian dictator in the promotion of market-oriented reforms, and, therefore, could have used a less violent method to resolve the Tiananmen Square protest. It is unlikely that Deng’s violent repressive conduct was motivated by personal power maximization. If Tiananmen Square was compared to the Cultural Revolution, Mao used the Cultural Revolution to take down political oppositions in order to regain his power. Deng was not faced with political oppositions before the June 4th 1989 incident. If Deng really cared about maintaining power, he would not have resigned as the Chairman of the Central Military Commission in late 1989.

However, it is most likely that Deng’s tyrant conduct was motivated by the political condition of the communist Soviet Union and Eastern European countries in the late 1980s. The communist regimes in these countries were faced with internal conflicts and international criticism as a result of economic stagnation, and political and social problems. The Revolutions of 1989 led to the down fall of the communist regimes starting with Poland, Hungary, East Germany, Bulgaria, Czechoslovakia, and then Romania. The Soviet Union was also dissolved soon after in 1991.

Given the international climate, probably Deng was more afraid of the down fall of communism in China then of his personal power accumulation. On June 16th 1989 after the Tiananmen Square massacre, Deng, in his speech, said:
The imperialist Western world attempts to make all socialist countries give up their socialist road and go under the monopoly rule of international capitalism. We should hold tight to resist the trend, holding the flag clear and high. If we do not persist in socialism, eventually we will only become a dependent nation, and it will not be so easy to become economically developed. Only socialism can save China, and only socialism can develop China.

Even after Deng stepped down as the de facto leader, he kept promoting economic reforms. In 1992, Deng made the famous southern tour to the coastal cities of Guangzhou, Shenzhen, Zhuhai, and Shanghai. During this trip, Deng continued to push his economic reforms. In his speeches, Deng stressed the importance of economic reforms and of opening China to the outside world.

9. Conclusion

Deng’s pragmatism contributed to his political ascension and market-oriented economic reforms. His pragmatism also allowed him to maneuver his way to the de facto leadership in a political system driven by ideology. Without any ideological confinement, Deng was able to break away from China’s unique history and culture, and lay down the foundation to a modern China. Even though Deng made the greatest contribution to China’s economic development, the June 4th 1989 incident proved that Deng was not truly a benevolent dictator. Deng’s achievements as the de facto leader of China were purely driven by his pragmatism.
1. **Introduction**

The socialist economy of China experienced a turning point in the late 1970s after Deng Xiaoping took the role as the de facto leader of China. With the new leader in place, China experienced rapid economic growth, growth that has persisted throughout the last three decades. The fundamental contributing factor for the rapid economic growth is the changes that have occurred in growth promoting institutions. “Institutions are the rules of the game in a society, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic.” (North, 1990)


The founding father of People’s Republic of China Mao Zedong was eventually referred to by most people in China as the “Great Leader Chairman Mao,” for his achievement in unifying China against the KMT and Japanese invasion prior to and during WWII. Mao established the People’s Republic of China on October 1, 1949 and became the Chairman of China.

Chairman Mao’s monopolized political power and economic central planning constructed an economy with inefficiencies, destroyed private property rights, and created a lack of proper incentives for actors to engage in profit-seeking activities. Mao’s extreme economic actions can be explained by the political and economic conditions...
prior to the establishment of the People’s Republic of China and by his self-interest in maximizing his personal political power.

To restore the economic, social, and political conditions after the establishment of the People’s Republic of China in 1949, Mao took centralized control of economic planning, which was aimed at guiding China’s economy back to a positive growth path. A centralized process for economic planning required Mao to accumulate and consolidate his political power in the CPC. The process of economic decision making at the central level and its implementation at the provincial level required political credibility at the central level and political support at the provincial level. The combination of centralized economic planning and the consolidation of political power helped to fulfill Mao’s objectives of power as a personal interest, and economic growth as a national interest.

The centralized economic planning approach may have had the beneficial effect of resolving distorted economic functions in a period of chaos. The problem of China’s low accumulation of physical capital, human capital, and technology was severe after the war. On the one hand, the war directly destroyed physical and human resources. On the other hand, the war created the roving bandit effect (Olson, 2000), which posed a great risk in terms of people’s production being taken away from them by the roving bandits. Therefore, people lacked the incentive to improve their productivities through the accumulation of physical capital, human capital, and technology.

To correct this dysfunctional economy, Mao implemented a set of economic institutions designed to improve China’s productivity and economic growth through central planning. The first economic reform “The First Five-Year Plan” was implemented
by Mao in 1953 to advance technological progress. The goal of the state was to build up
technologically sophisticated, large-scale, capital-intensive plants.

Mao understood that technological progress was the key to China’s economic
growth. With the advantage of political and economic information, the state was able to
prioritize its capital resources into the industrial sector. The industrial sector consisted of
carbon, electric power, iron and steel, building materials, basic chemicals, and heavy
engineering.

Central economic planning through collective effort to speed up growth was the
intention of Mao’s First Five-Year Plan. At the initial stage of the industrial sector,
capital and financial resources were scarce and short-run fixed costs were high. It was
less feasible for private businesses to acquire the resources to fund and establish
businesses in the industrial sector. One of the more feasible alternatives was for the state
to occupy these industries. The perceived advantage of the state was its ability to fund
these industries through taxation and the ability to set price ceilings on raw materials.

The result of the first five-year plan through centralized control was the formation
of the State-Owned Enterprises (SOEs). One of the features of the SOEs was the lack of
autonomy in the production planning process. Since the state controlled all the economic
information, the SOEs allowed the state to provide the directions on what to produce,
how much to produce, what materials were to be used. Since the productions were
centrally planned, all raw materials and funding in the production process were also
centrally distributed. Since the state did not have the managerial ability to run SOEs,
managers were hired to run the SOEs for the state. Rather than controlling the enterprises
directly, the state oversaw the managers of each enterprise, albeit at a high cost in terms of agency inefficiencies.

As the owner of the SOEs, the state served the function of providing all inputs and covering all costs to the production process of the enterprises. The state also set the wage rates for the workers and managers of the SOEs. The managers of the SOEs coordinated the production process between inputs, capital, and workers. All outputs generated from production were to be delivered to the state. This separation of ownership and control is comparable to a large corporation. However, market constraints are closely absent.

The economic growth of the First Five-Year Plan was very successful in the industrial sector. Industrial production increased at an average annual rate of 19 percent between 1952 and 1957, and national income grew at a rate of 9 percent a year. The GNP per capita estimated by Liu-Yeh rose from 129.9 billion in U.S. dollars in 1952 to 173.2 billion in U.S. dollars in 1958. (Eckstein, 1975) However, the growth of the agricultural sector was sluggish compared to the industrial production. The average agricultural output during this period was about 4 percent a year.

The fundamental problem of the First Five-Year Plan was a lack of sufficient capital to vitalize both industrial and agricultural productions. To resolve this imbalance between industrial and agricultural production, Mao introduced the “Great Leap Forward” in 1958. The goal of the Great Leap Forward was to double the production of steel and agricultural goods based on the 1957 production level. (Tsou, 1986) Mao believed that both sectors had to grow in order to support each other economically. The
industrial work force needed to rely on agriculture to be well fed, while the agricultural work force needed to rely on industry for modern tools.

For the perceived purpose of mutual benefits to the agricultural and industrial sectors, in 1958, people’s communes were established in rural areas to achieve maximum mobilization through the use of collective labor. The communes were the highest of the administrative bodies in the rural area and each commune was divided into production brigades and production teams. Twelve families formed a team, while twelve teams formed a brigade. Under the commune system, everything was shared. All the families in the same commune had to contribute everything from stored food to cooking utensils. Private kitchens were abandoned and people were not allowed to eat with their families. Free-rider problems were rampant in such conditions. All farming activities were centrally assigned by the commune leaders, while the production output was procured by the state.

The commune system further enhanced the state’s ability to gain control of the production channels of all the rural agricultural land by destroying private property rights. The result was the state controlled all the physical, natural, and human resources in the rural areas. The destruction of private rural property rights allowed the state to redistribute the agricultural resources to enhance the growth of industrial sector. The state’s procurement system pushed agricultural prices below the market equilibrium, so that the industrial workers benefited from reduced food prices but experienced lower supplies. The procurement system also reduced the prices of industrial products, which
helped the farmers to acquire more sophisticated agricultural tools at cheaper prices, when such products were supplied.

Through the commune system, people in the countryside were not only directed to produce agricultural goods, but also steel. To produce steel on a massive level, backyard furnaces were utilized. These furnaces were built in the backyard of every commune, and were used to melt any steel objects available to make steel girders. In a similar fashion to agricultural production, local governments set up the target for steel production. The problem with backyard furnace steel production was that people lacked the education and knowledge to produce high quality steel, thus most of the steel produced was useless. The loss of scale economies raised production costs. Therefore, backyard furnace production was a major failure of the Great Leap Forward, and was quietly abandoned in 1959.

Among Mao’s economic policies, the Great Leap Forward from 1958 to 1961 was the most significant economic policy which resulted in a severe economic and political crisis. The Great Leap Forward was aimed at modernizing China’s economy by revitalizing the agricultural and industrial sectors of the economy through collectivization. The economic effect of the Great Leap Forward was a sequence of economic crises. Because of the state’s control over resources, combined with severe, bad weather in 1958, 1959, and 1960, China experienced nation-wide spread of famine. (Cannon and Jenkins, 1990) The widespread famine occurred especially in rural areas because many food resources were being exported to urban areas. In 1960, the agricultural output fell by 13 percent, and in 1961 it dropped to 15 percent, and reached the lowest level in 1952. (China’s Statistical Yearbook, 1963) The GNP per capita, as
estimated by Liu-Yeh, fell from 173.8 in 1958, to 147.2 in 1960, and continued falling to 135.6 in 1963. (Eckstein, 1975)

The catastrophic economic outcome of the Great Leap Forward also resulted in the death of tens of millions of people in China. In this respect, Mao was a mass murderer, on a larger scale than either Stalin or Hitler. The combination of flood, drought, and slow agricultural growth led to nationwide starvation. From 1959 to 1961, the estimated death from starvation was between 15 million to 40 million. (Wemheuer, 2010) Historian Frank Dikötter viewed the Great Leap Forward as “one of the most deadly mass killings of human history.” (Dikötter, 2010)

The consequence of this failed economic policy was the self-exile of Mao in 1959, and the uprising of the right-wing leaders, Liu Shaoqi and Deng Xiaoping. Soon after coming into office, in the late 1960s, they abandoned the Great Leap Forward. Even though Mao’s power authority in the CPC was lost, he was still viewed as a great leader outside of political circles, and was seen by most people as the leader of revolution. His continued popularity among the people of China was the basis which allowed him to regain his political authority. Mao’s comeback in 1966 signified the turning point in his extreme political approach as a tyrannical leader because he was driven by pure political self-interest.

In 1966, Mao launched the Cultural Revolution, in an attempt to regain his power from Liu Shaoqi. To legitimize this political action, Mao claimed that the bourgeoisie was permeating the CPC and society, and must be removed in order to prevent capitalism
from taking place in China. Using Marx’s concept of class struggle, the Red Guard was formed to remove the liberal bourgeoisie from society.

The initial movement of the Red Guards focused on the attack of the “Four Olds.” Old books and arts were destroyed, streets were renamed, and many famous heritage sites were also destroyed. Posters of Mao and his popular sayings were everywhere. (Meisner, 1986) After the attack on the “Four Olds,” the Red Guards then launched their attack on the people, particularly anti-revolutionary politicians and intellectuals. The Red Guards attacked people physically and psychologically, and many Chinese subjects were shot in this movement. Politicians were denounced and intellectuals were sent out to villages to do manual labor. (Meisner, 1986) In particular, Mao’s political opponent Liu Shaoqi was sent to a detention camp for life, and Deng Xiaoping was sent away three times for re-education. As reported in October 1966, 22,000 anti-revolutionaries were arrested. (Karnow, 1984)

The adverse effect of this social and political movement lasted for many years after 1968, and smaller scale Red Guard groups continued to organize attacks. The Cultural Revolution was a period of nationwide economic and political chaos. Industrial production was badly affected by the uprising. Per capita output in agriculture in 1977 stayed at the same level as it was in 1957. (China Statistical Yearbook, 1978)

Following the Cultural Revolution movement, Mao implemented the “Down to the Countryside Movement” on a nation-wide scale. Young middle school graduates in the cities were ordered to live in the mountainous areas and villages to do manual labor or farming. As a result, these young graduates lost their opportunity to attend university.
This movement shows the continuation of Mao’s anti-bourgeois political ideology. These young city graduates were eventually allowed to return home in the late 1970s.

Mao’s extreme political actions implemented after regaining his power authority were ended after his death in 1976. Mao’s death signified the downfall of socialist central economic planning and was followed by an era of new leadership, evidenced by totalitarian rather than by tyrannical politicians.


China’s transition to a market economy began in 1978, after Deng became the de facto leader of China two years after Mao’s death. With the ideological shift introduced by Deng Xiaoping, a new set of institutions was implemented to enhance the incentives of the economic actors in production and trade at the provincial level. These institutional changes made by Deng at the provincial level resulted in the rapid economic growth in China over the past three decades.

At the provincial level, each province consisted of counties, towns, districts, and villages. All economic activities could be conducted at any level within a province. In general, economic activities at the provincial level were categorized under the state sector, collective sector, private sector, and agricultural sector.

Deng’s initial economic reforms faced many difficulties. The leaders of China at that time did not have any well thought out objectives on how to proceed with economic reforms, but Deng realized that, in order to advance China to a higher standard of living, it was necessary to break away from Mao’s centralized economic planning. To accomplish this pragmatic economic goal, Deng had to abandon communist ideology.
Deng’s pragmatic approach to economic growth was reflected in his famous phrase “do not care if the cat is black or white, what matters is it catches mice. For Deng, economic development must be separated from political ideology, and capitalist economic concepts did not conflict with socialism.

However, breaking away completely from Mao’s centralized economic planning was very risky from a political perspective. Since Mao had just passed away, his established political base was very strong with large numbers of loyal supporters inside the CPC. Since Deng’s reformist faction was still small at the time, he had to be cautious when making reforms. Reforming the old system would produce resistance from various interest groups faced with potential political and economic losses.

During economic reforms, political resistance by different interest groups must be taken into serious consideration before new institutions can be implemented. When implementing a set of institutions at the national level, major interest groups are heavily affected by the institutional changes, both economically and politically.

Without the support of the interest groups, these institutions are likely to fail. To determine the likelihood of political resistance or support, costs and benefits of the interest groups involved must be evaluated and weighed during the transition. If the costs of making economic and political reforms are too high for these interest groups, they would create a formidable resistance to make sure that those reforms would not be realized.

Therefore, making reforms slowly and gradually made political sense to Deng. The failed shock therapy, as evidenced by the Former Soviet Union in the 1980s, required
paying high political costs and generated social and economic chaos at the same time. A gradual approach on the other hand, could develop new institutions without breaking down the old system immediately, thus reducing political resistance from different interest groups.

The fundamental problem with Mao’s centralized economic planning, or socialist economies in general, was the lack of established property rights. Without established property rights, economic actors have no incentive to produce efficiently and engage in mutually beneficial trade. An established property rights system promotes economic growth through trade. However, a well-established property rights system contradicted the CPC’s political agenda. If the CPC lost its control over China’s property rights, they would also lose their ability to make centralized political and economic decisions.

When faced with this paradox, Deng chose to reform China’s economic system gradually to minimize political resistance. With the gradual approach, Deng implemented a series of economic institutional changes, step-by-step. Since these reforms were taken step-by-step, huge resistances were broken down into smaller ones. Not only did they minimize political resistance, Deng and his reformist faction intelligently created different incentive structures through each step of the way. Implementing these steps helped to resolve any potential conflicts among different interest groups involved, and promoted cooperation between these parties. Furthermore, each step of the way laid down the foundation for the succeeding institutional change in the next step.

The initial wave of reforms started in 1979. The profit-retention program in the state sector, and the contract-responsibility system in the agricultural sector, were two
complementary institutions aimed at bringing greater economic autonomy to the cities and rural areas. The profit-retention program was created to allow the state run enterprises to retain a percent of improved profits, instead of submitting full profits to the state finance department. The profit-retention program was introduced as the first economic reform with market characteristics, which allows the SOEs to retain 12 percent of increased profits or reduced losses. The increased profits retained by the SOEs could be used for paying bonuses, welfare programs, and investments.

Around the same time, the contract-responsibility system was established in agricultural production. The responsibility system permitted farmers to work a piece of land for profit in return for delivering procurement quota to the state. The contract-responsibility system was essentially a contractual relationship between farmers and the state. By signing a contract, farmers were permitted to work a piece of land for profit in return for delivering a fixed procurement quota to the state.

By the end of 1983, 98 percent of rural households in China signed contracts with local authorities. The effect of land contract liberalized rural laborers from traditional collectivism and the commune system. This process allowed the state to liberalize and transform rural laborers into profit-seeking economic actors without having to decentralize the central planning process of the state.

The state also began to experiment with market-based prices for resource allocation in order to provide incentives for increased production. The SOEs were allowed to sell some of their outputs and buy some of their inputs in the market and were permitted to keep some fraction of their profits. Managers of the SOEs were given
monetary rewards based on the performances of their SOEs. The right to decide what to produce, how much to produce, and how to produce it, was shifted from the state to the SOEs. (Byrd, 1991)

The dual-track system was established in 1984. This institutional reform signified the first step the central government took toward market liberalization. The dual-track system was an economic reform in which the introduction of the market-track ran simultaneously in parallel with the conventional planned-track. Under the planned track, economic agents were assigned production quota of goods and services at fixed prices. Under the market-track, any extra production above quota could be sold at market prices. The dual-track system provided the opportunity for collective and private enterprises to engage in trade, establishing their competitive advantages over the state controlled SOEs.

To facilitate the growth of the market track, Deng also introduced a set of fiscal decentralization policies at the provincial level. Prior to market liberalization, taxation were collected by the state and redistributed centrally to the provinces according to their budget needs. With the new fiscal policies, the local governments were given the right to collect taxes, manage their own budgets, and share tax revenue with the central government. Fiscal decentralization provided additional motivation for provincial governments to promote economic growth at their regions, which reinforced the establishment of the market track.

In 1980, the “revenue-sharing system” was enacted to provide semi-autonomy in the fiscal administration at the provincial level. In some provinces, tax revenue was shared between the central government and regional governments at a fixed ratio based
on historical expenditure of provincial governments. In other provinces, tax revenue was
divided between the central government and regional governments at a variable-ratio.
The tax ratio depended on the type of taxation, such as tax on local enterprises, salt tax,
agricultural tax, industrial tax, and commercial tax.

The second step of reform “all-round fiscal responsibility system” was introduced
in 1988. Generally speaking, the ratio between the central government and regional
governments depended on a predetermined revenue growth rate. If realized revenue
exceeded the predetermined growth rate, regional governments would retain the surplus.
Realized revenue below the predetermined rate would be shared by the central
government.

An astonishing result of the above reforms was the entry and rapid growth of
collective enterprises, especially township and village-owned enterprises (TVEs). Most
of these TVEs were collectively owned. The property rights belonged to the collectives,
while managers were given the right to contract. The TVE included a wide range of
business from small cottage industry to complex factories producing exporting goods.

Given the prior economic condition and the imperfections of a newly established
market, the unique property rights structure of TVEs was probably the best alternative to
the well-established private property rights in a fully developed market economy. TVEs
were used by community governments as a vehicle to transform community properties
into profit-seeking activities (Naughton, 1994). After economic transition took place in
the early 1980s, TVEs became the most dynamic sector in China’s economy. By the year
1993, the share of industrial output of TVEs was 27% compared to 9% in 1978. In the
rural areas, TVEs accounted for three-quarters of rural industrial output. (China Statistical Yearbook, 1994)

Deng’s dual-track system also facilitated the creation of private enterprises. The private sector emerged in the mid-1980s, with many private enterprises covered under the umbrella of TVEs, because they were not yet legally acceptable. Private enterprises were established out of self-interested profit seeking economic actors to meet increased demand in the market-track. Furthermore, meeting market demand created additional job opportunities which alleviated the issue of local unemployment.

The beneficial effects brought to the economy through the growth of the private sector led to the legalization of private enterprises. In April 1988, the Seventh National People’s Congress legalized private enterprise. This institutional change provided the safety net for private enterprises to grow without the risk of losing their ownership rights to the state. It also promoted local government officials’ supportive effort toward private enterprise. Without this institutional change, local officials’ supportive behavior toward private enterprises could have resulted in political punishment. Without worrying about getting punished, self-interested local officials could use private enterprises to create economic benefits for themselves and their communities.

Besides the development of domestic enterprises in the private sector, Deng understood the importance of opening up China to the world. This was Deng’s second important philosophical thought termed “gaige kaifang,” meaning reforms and openness. The strategy to attract foreign direct investment (FDI) became increasingly important in order to improve the dynamic of the newly established market economy. Through
attracting FDI, China was enabled to obtain financial capital, advanced technologies, and management skills. The early FDI came in the form of joint ventures. Over time, solely foreign-owned enterprises became the primary form of foreign investment.

The initial stage of opening up China’s market to foreign investors started with the development of the special economic zones (SEZs) in the coastal cities of Shenzhen, Xiamen, Shantou, Zhuhai, and gradual expansion toward other regions over the years. The key to the success of SEZs was the focus of preferential treatment on FDI through taxation. With the increasing demand and opening of new regions for FDI, the state’s policy on preferential treatment gradually diminished. New regions had to attract foreign investors based on their competitive advantages in geographic location, infrastructure, level of science and technology, costs of land and labor, and investment environment.

The series of economic reforms carefully implemented by Deng avoided political ideological clash within the CPC. However, rapid economic growth in the 1980s led to several new economic and social problems. On the economic front, rapid economic growth created a high level of inflation in the late 1980s. The price level in China before the introduction of the market-track was pushed below the equilibrium prices as a result of central planning. Through the introduction of market prices, inflation soared. In 1987, the inflation rate was 7.3 percent, and it jumped to 18.5 percent in 1988. (Zhao, 2001)

Also, increased dependence on market process affected job security. With the expansion of collective and private enterprises, employment in different sectors of the economy gradually shifted from the state and agricultural sectors to the collective and
private sectors. As a result, the “iron rice bowl” or secured jobs no longer applied to jobs offered in the collective and private sectors.

The expansion of these two new sectors also affected new graduates from college. Collective and private enterprises, with their ability to make independent decisions in business operations, were less likely to hire college graduates, and the state was no longer able to guarantee job placements for college graduates. Since many college graduates were over-qualified for these jobs and demanded higher salaries, they were faced with unemployment.

The increased unemployment of graduating college students was worsened by the “Two-Way Selection System” policy created in 1988. This selection system allowed private enterprises to reject job placements issued by colleges to their graduating students. The system unintentionally promoted the use of “backdoor” for people with connections to pay favors and bypass the standard hiring qualifications.

The development of the collective and private sectors also induced officials to misuse their power for personal economic gain, through rent-seeking activities. There were two types of rent-seeking prevalently practiced by the local officials: “tanwu shouhui” and “nuoyong gongkuan.” The practice of “tanwu shouhui” involved local officials exploiting their political positions to extract bribes, while the practice of “nuoyong gongkuan” involved local officials using public resources for personal benefits. (Manion, 1997)

Tanwu shouhui rent-seeking activity became popular when collective and private enterprises, in order to grow their businesses, required the support of their local officials.
Because the local officials were endowed with political and economic resources, the collective and private enterprises had to compete among themselves for these valuable resources. To gain a competitive advantage, the enterprises had to bribe local officials in exchange for these resources.

Around the same time, as a result of the transformation of the fiscal policy, Nuoyong gongkuan rent-seeking activity also became popular. Prior to Deng’s economic reforms, fiscal policy provided little incentive to local officials to maximize profits. The revenues generated by local governments were procured by the state, which in turn provided local governments with budget allocation for expenditures. (Oi, 1995)

After Deng’s economic reforms, fiscal policy was decentralized at the township and village levels. Local governments were given the right to collect taxes and manage their own budgets. Since tax revenues were under the direct management of local officials, and the state was unable to effectively monitor the use of these revenues, a portion of these revenues was used by local officials for personal benefits.

All these economic and social problems generated from Deng’s economic reforms also generated widespread dissatisfaction with the central government among the general public, particularly among educated college students. Not only were they unhappy with these new economic and social issues, they also were seeking greater political freedom. This tension between the central government and the general public eventually led to the June 4th 1989 Tiananmen Square incident.

After the June 4th 1989 incident, Deng’s political credibility was weakened both within the CPC and among the general public. On the one hand, Deng was under political
criticism from the leftist faction for the accumulated economic and social problems generated from economic reforms. On the other hand, Deng was criticized by the general public for his extreme use of military action in the June 4th 1989 incident.

In late 1989, when faced with political and social pressure, Deng stepped down as Chairman of the Central Military Commission. Deng was succeeded by Jiang Zemin, who became the General Secretary of the CPC on June 24th, 1989. Even though Deng stepped down from the political center stage, his influence in the CPC was still strong and he operated from behind the scene.

Deng Xiaoping passed away on February 19th, 1997. During his last several years, he still made significant contributions to China and made sure that the next generation political leaders continued his path with China’s economic development. In 1992, Deng made the famous southern tour to the coastal cities of Guangzhou, Shenzhen, Zhuhai, and Shanghai. During this trip, Deng continued to push his economic reforms.

In his speeches, Deng stressed the importance of economic reforms and opening China to the outside world. Initially, Deng’s successor, Jiang Zemin, instructed the national media to ignore Deng’s southern tour. However, Jiang eventually aligned with Deng on this issue and allowed media reporting at the national level. Jiang’s decision to aid Deng came from a political reason, ensuring his legitimacy as Deng’s successor.

To reinforce Jiang’s cooperation with Deng’s economic ideology, Deng endorsed Zhu Rongji as the Premier of China. Like Deng, Zhu was pragmatic on economic reforms and shared similar economic ideological thinking with Deng. As the Mayor of Shanghai
in the late 1980s, Zhu was experienced with overseeing the development of Pudong, an SEZ between Shanghai and East China Sea.

Deng’s last contribution to China was his negotiation with the United Kingdom on the return of Hong Kong to China. Deng met with British Prime Minister Margaret Thatcher and negotiated for the return of Hong Kong. During the meeting, both parties made compromises, and Deng proposed to use “One Country Two Systems” to ensure Hong Kong’s capitalist economic and political systems for the next 50 years. On December 19\textsuperscript{th}, 1984, the Sino-British Joint Declaration was signed, which stated that Hong Kong would return to China by 1997.

Hong Kong was returned to China officially on July 1\textsuperscript{st}, 1997, several months after Deng’s death. Even though Deng was not alive to see this historic event, he will always be remembered by the people of China for this event, and more importantly, for his liberal and pragmatic approach to China’s economic development.


Jiang became the General Secretary of the CPC on June 24\textsuperscript{th}, 1989 and the President of China on March 27\textsuperscript{th}, 1993. Prior to taking the leadership position, Jiang Zemin was the Mayor and Party Chief of Shanghai. As the Party Chief of Shanghai, Jiang automatically became a member of the Politburo of the CPC Central Committee, the highest authority within the CPC. Jiang was appointed as General Secretary of the CPC soon after the June 4\textsuperscript{th}, 1989 incident, replacing Zhao Ziyang.

After Jiang succeeded Deng, he lacked a strong political base. As the former Shanghai mayor, he was not involved with Beijing’s politics. Also, Jiang did not have
military experience. So the first initiative Jiang took as a leader, before tackling economic issues, was to consolidate his political power base. As a dictatorial leader, Jiang understood the importance of commanding the military, and skillfully engaged in economic exchanges with top military commanders in order to win their political support.

To validate his control over the People’s Liberation Army (PLA), Jiang with the help of Deng, removed military veteran Yang Shangkun and his cousin Yang Baibing from the Central Military Commission (CMC), the highest military policy-making body in China. Yang Shangkun was the Vice-Chairman of the CMC and the President of China before Jiang came into office.

Yang Shangkun was one of the most powerful military figures in the 1980s and he commanded the PLA during the June 4th 1989 incident. Yang’s cousin Yang Baibing worked as the Secretary General of CMC, and his nephew Yang Jianhua commanded the 27th Group Army. Together, they were called the “Yang family clique.” Many senior leaders felt threatened by the Yang family’s dominating military force. (Eckholm, 1998)

In contrast to Deng, Jiang offered military generals greater political participation, in return for their loyalty. Starting in the mid-1990s, top military generals were allowed to participate in the state meetings. This greatly increased the military’s ability to bargain with the state officially, rather than relying more on informal network and marketization. Jiang also made great effort in the modernization of the military, providing the military with high-technical equipment and preparing soldiers for modern warfare capabilities.

At the same time, Jiang also took an initiative to restrain the PLA’s power. As one lever, 500,000 soldiers were cut from the PLA in 1997. As another lever, Jiang put in
place a strict retirement system on all the generals, limiting their ability to accumulate military power and to expand their political networks.

Finally, Jiang curtailed the commercialization and marketization of the military. The PLA was uniquely established with a self-sustainable production system. The PLA had its own food production system, housing, and factories. The PLA was able to take advantage of marketization in the 1980s. Through the dual-track system, military generals made the decision to sell extra food production in the market. In addition, the PLA commercialized its housing by converting guest housing into hotels.

Profits made in the marketization process during Deng’s era brought extra budgets into the PLA, so that the PLA became increasingly independent. This method may have worked well for Deng, but Jiang lacked the military credentials to follow Deng’s method. Therefore, Jiang required the PLA to shut down its commercial businesses and turn them over to the state.

After consolidating his power in the PLA, Jiang aimed at restructuring the SOEs. Since the SOEs held major economic power in the early 1990s, Jiang had to constrain the economic power of the SOEs out of both political and economic reasons. If the SOEs were left unconstrained, at some point in time, their economic motivations might run counter to the political agenda of the CPC. In addition, debt accumulation of the SOEs became unmanageable as a result of the state’s policy of soft budget constraint.

The soft budget constraint allowed SOEs to borrow loans from state run banks with relative ease. Because SOEs operated inefficiently, had easy access to bank loans, and borrowed without the risk of default on their loans, they were induced to borrow
more loans than was necessary for efficient operation. Loans borrowed by SOEs grew from 190 billion RMB in 1978 to 7.5 trillion RMB in 1997. (Lardy, 1998)

In 1995, Jiang implemented the reform “grasping large enterprises and letting go of small enterprises,” to reduce the size of SOEs and to restructure the remaining SOEs. By letting go of control of medium-sized and small-sized SOEs, the state was able to focus its energy on the one thousand large-sized and medium-sized SOEs. The state was able to get rid of smaller-sized SOEs through merger, leasing, contracting, offering for sale, or bankruptcy. To improve the efficiency of the large and medium SOEs, the state separated the administration and management functions of the SOEs.

In the early 1990s, in order to shelter himself from political attack against his economic reforms, Jiang elevated “Deng Xiaoping Theory,” particularly stressing the concept of building socialism with Chinese characteristics. Jiang’s initial dependence on Deng’s political and economic ideology determined Jiang’s pathway to China’s economic reforms. Jiang Zemin continued with Deng Xiaoping’s legacy and minimized repression with greater economic autonomy through increasing economic privatization and legalizing private enterprises.

The reform policy on SOEs helped China to develop into a more market-oriented economy, relying more on market price mechanism and less on state directed production. However, reducing the size of the state sector created an immediate negative impact on employment starting in 1995, the same year that the state sector’s reform policy took place. According to the official forecast by the Labor Ministry in 1995, labor force would
China’s unemployment issue in the 1990s was further exacerbated by the migrant workers (mingong) moving to the cities from the countryside. Migrant workers were surplus laborers in the countryside, and were made obsolete by modern farming technology. Most migrant workers came from Sichuan, Hunan, Henan, Anhui, and Jiangxi provinces. They often found work in Beijing, Shanghai, Shenzhen, and other coastal cities.

Migrant workers often left their children with their parents in the countryside while they sought work in the cities. Migrant workers had the advantage over urban workers since they were cheaper to hire. And cheap labor was in high demand because of the rapid economic growth and expansion in the cities.

Although migrant workers contributed to the economic development of the cities, they also created many social problems. Migrant workers seeking jobs in the cities created employment pressure on urban workers. Also, mass mobilization of migrant workers generated social instability. Migrant workers were more likely to protest if they are laid off because they were reluctant to go back to the countryside. If they returned home, they created extra burdens in the countryside because jobs there were very limited. So, migrant workers were basically stuck in the cities.

Because Jiang himself did not specialize in economics, he relied on Vice-Premier Zhu Longji to resolve many of the economic issues created from economic reforms since Deng. In the early 1990s, inflation was a major economic problem inherited from Deng.
Zhu enacted four years of tough macroeconomic control in an effort to reduce inflation. In March 1998, for his success in curbing China’s inflation, Zhu was promoted to China’s Premier. As the Premier of China, Zhu focused on continuing development in the industrial and agricultural sectors, accelerating the privatization process, while closely monitoring the monetary system. Zhu’s effort in overseeing China’s economy contributed to China’s double-digit growth in the 1990s.

To further strengthen China’s economic power, Jiang and Zhu worked hard to collaborate with the international system. China’s rapid economic development in the domestic market attracted greater foreign direct investment (FDI). While FDI in the world shrank in 2000, China’s inflow of FDI rose by 10 percent and it rose by 22.6 percent in 2002. In 2002, China became the largest FDI recipient in the world. Out of the world’s top five hundred nonfinancial corporations, China had attracted more than four hundred of these multinational corporations in investment. (Wu, 2005)

A major step toward China’s economic development both domestically and internationally was entry into the World Trade Organization (WTO) in 2001. It signified a new era of China’s international economic and trade integration. The admission to the WTO meant that China’s past economic transformation since 1978 was successful in terms of economic growth and economic liberalization. During the years of negotiation with the WTO, the Chinese government made an effort to deregulate trade related institutions in order to improve their success in becoming a WTO member. Over the years, tariff barriers were dramatically reduced and import quotas were eliminated. (Wu, 2005)
Following Deng’s footsteps, Jiang Zemin, with the help of Zhu Rongji, further enhanced the political and economic conditions in China. Without military credentials or any strong political base in Beijing, Jiang cautiously managed China’s social condition while keeping military use to a minimum. Jiang’s economic and political institutions provided the necessary ingredients for continued double-digit growth in the economy and political stability in China. Even though Jiang was viewed as a transitional leadership figure, what Deng left incomplete, Jiang accomplished for China’s economic development.

Deng’s economic reforms provided the foundation for China’s market economy, referred to as socialism with Chinese characteristics. With this economic foundation in place, Jiang, then, took China’s economy to the next step, which is referred to as socialist market economy. The greatest contribution Jiang made during his leadership was probably the entry into the WTO, which further opened China’s economy in the global market with new possibilities for decades to come.


After Jiang Zemin stepped down from the Politburo Standing Committee of the CPC in 2002, Hu Jintao succeeded Jiang and became the General Secretary of the CPC. Hu was the first leader in the People’s Republic of China to secure a peaceful succession without political conflict among various political factions. This was a milestone in China’s politics, in contrast to the succession from Mao Zedong, to Deng Xiaoping, to Jiang Zemin. Hu’s succession demonstrated a gradual advancement in China’s political system and improved political transparency.
Hu succeeded Jiang as the President of the People’s Republic of China on March 15th, 2003, while Jiang retained his chairmanship of the Central Military Commission. Jiang could practice his influence behind-the-door, like Deng Xiaoping, but he was quiet after stepping down from the political center stage. Jiang officially left China’s political scene, when he resigned as the Chairman of the Central Military Commission on September 19th, 2004.

Hu’s smooth transition to succeed Jiang took place in 2002. As a new leader, Hu inherited many economic and social problems from Jiang, which had originated in Deng’s economic reforms. Since Jiang followed Deng’s footsteps in deepening China’s economic reforms, these economic and social problems were amplified at the end of Jiang’s term. Hu’s first task as a new leader was to tackle these problems. Hu’s support on these economic and social issues came from Wen Jiabao, who, in 2003, succeeded as premier of China after Zhu Rongji.

Wen Jiabao shared a similar career path with Hu. Wen majored in engineering and studied geomechanics for his post-graduate degree. Wen began his political career working at the Geology Bureau of Gansu and was promoted as the chief of Gansu Provincial Geological Bureau. Like Hu, Wen was also discovered by Hu Yaobang, who gave him the opportunity to join the Politburo Central Committee. Wen served as the director of the Party’s General Affairs Office, and oversaw daily operations of the party leaders.

In 1998, Wen joined Zhu Rongji’s faction, serving as China’s vice premier under Zhu, which helped Wen to gain valuable economic experience. Wen became the premier
of China in March 2003. Wen’s economic experience, his eloquent communication skills, his personal charisma, and his ability to reach out to people made him an ideal person for the job.

The Hu Jintao and Wen Jiabao alliance was compared by many to the alliance between Mao Zedong and Zhou Enlai. Hu’s discipline and his ideological mind combined with Wen’s image of “the people’s premier” were very similar to the Mao and Zhou partnership. Together, Hu and Wen’s core political and economic philosophies were to create a “harmonious society” and to reduce income inequality by helping the “ruoshi tuanti” or disadvantaged groups. (Lam, 2006) More specifically, Hu and Wen tried to reduce the gap between China’s hinterland and coastal cities generated from SEZs.

To bring greater economic equality, Hu and Wen focused a greater amount of attention on the peasant population, which represented a majority of the Chinese population. To improve the economic condition of peasants, tax cuts and subsidies were introduced in 2004. Prior to this policy change, farmers were burdened with up to sixty different types of fees and levies by the local governments. (Lam, 2006)

At National People’s Congress, Wen announced that the standard 8 percent agricultural taxes would be abolished in five years. Hu and Wen also promoted competition among regional governments to provide agrarian subsidies. In the year 2003, subsidies which came directly from the central government were increased by Hu and Wen from 800 million yuan to 299.9 billion yuan,
The education system was another major issue faced by the majority of peasants living in the rural areas. As reported by the United Nations in 2003, China spent only 2 percent of GDP on education. Children of migrant workers were faced with even greater difficulties. Since these children were usually raised by their grandparents, they were more likely to drop out of school during their teenage years.

To relieve China’s poor education in the rural regions, the central government announced, in the Eleventh Five-Year Plan in 2005, a spending plan of 218 billion yuan on rural education in the next five years. This budget increase was aimed at covering education expenses, such as books and unpaid teachers’ salaries, in impoverished western provinces. Wen had announced his goal to the media of providing free education to 85 percent of the children in the western provinces.

Compared to the rapid economic and social progress made by Deng and Jiang, Hu was not nearly as effective in reforming China. On some aspects, many viewed Hu on China’s economic, political, and social developments as stepping backward, rather than moving forward. Among Hu’s policies, those that stand out are: his use of media control, and the strengthening of the SOEs.

The central government had always relied on media control to reduce social conflicts and to promote the CPC’s political images. With the rise of the internet age, the information flow became more rapid. Major domestic and international events became more widespread and travelled instantaneously from one place of the world to another. Also, given Hu’s priority of maintaining a harmonious and stable society, a sensible step was to control China’s media sources, particularly the internet.
Under Hu, the central government used a tightly controlled system to shut down any publications or websites on the internet criticizing the CPC, central government, and political leaders. Hu’s harsh media control was evident in the jailing of journalists and bloggers. The most noteworthy among these cases was the jailing of Chinese activist Liu Xiaobo, who received the 2010 Nobel Peace Prize after he was put in jail by the Chinese government. (Bennett, 2011)

With China’s rapid economic growth over the past two decades, driven by private enterprises and foreign direct investment, SOEs were often left out of the picture. In the 1990s, SOEs were dramatically reduced in size under Jiang’s policy of “grasping the big and letting go the small.” This policy was implemented to cope with the large volumes of debt incurred by SOEs which could not be handled by the central government. The financial problem of SOEs forced the central government to let go of smaller sized SOEs and to restructure bigger sized SOEs.

Even though the share of SOEs continued to decline in the 2000s, major existing SOEs have strengthened under Hu. From 1999 to 2008, the average asset size of industrial SOEs increased from 134 million RMB to 923 million, an increase of 589 percent in 9 years. (Xu, 2010) These SOEs continue to increase their share in the economy, domestically and internationally, by purchasing foreign companies.

The expansion of SOEs helped to serve the political objectives of the party in terms of political stability in China and improved competitiveness in the international arena. This trend of strengthening existing SOEs is very likely to interfere with China’s
sustained economic growth in the near future. More importantly, it may slow down the process of economic liberalization.

In 2012, Hu will complete his second term as the president of China and the general secretary of the CPC. When he steps down, he has named Xi Jinping as his successor. Under Hu, China has continued with its rapid economic growth, with an average rate close to double-digit. Unlike Deng and Jiang, Hu did not make major economic institutional changes. Instead, Hu followed the economic momentum, riding the growth wave while taking precautionary measures to ensure a harmonious society and the political stability of the CPC.

6. Xi Jinping: Princeling Totalitarian and Unknown Quality
Similar to the last succession from Jiang Zemin to Hu Jintao, the coming succession from Hu Jintao to Xi Jinping will most likely be a peaceful one. A peaceful succession would reflect the gradual progress in China’s political system, and improved checks and balances within the CPC. An independent decision making dictator is no longer feasible in China’s political system today.

Since Xi is still waiting in line for his succession as the next generation leader of China, whether Xi will continue with China’ pro-market economic development after succeeding Hu is not certain. Will Xi continue with China’s market-oriented economic reform, and will he be bold enough to also initiate political reform? What might help to answer this question is to consider Xi’s upbringing, his political background as a princeling politician, and his characteristic as the Vice President of the People’s Republic
of China. Assembling these pieces of a puzzle will help to shed light on whether China will become a freer country or a more repressive country under Xi’s new leadership.

Xi is a princeling politician who built his political career using the connections of his father Xi Zhongxun, a communist veteran under Deng Xiaoping. Xi’s father was one of the more liberal party leaders who proposed and implemented the first SEZ of Shenzhen. Xi’s father is also considered one of the mentors of Hu Jintao and Wen Jiabao.

As a princeling politician, Xi climbed the political ladder with relative ease, served in the provinces of Hebei and Shaanxi, the rich coastal provinces of Fujian and Zhejiang, and the city of Shanghai before working in Beijing.

Like many new generation top politicians, Xi studied at Tsinghua University and majored in Chemical Engineering. After graduation in 1979, Xi immediately served as the secretary for Geng Biao, the vice premier and the Secretary-General of the Central Military Commission at that time. Geng Biao was the former subordinate of Xi’s father.

In 1982, Xi became the secretary general of Zhengding County of Hebei. Xi’s significant political career began in 2000 when he was promoted to be Governor of Fujian province. As Governor, Xi facilitated free market economic development and attracted major investments from Taiwan.

With his father’s political connection, Xi accumulated his political experience quickly. In just two years, Xi was transferred from Fujian to the neighboring province of Zhejiang in 2002, and served as the Governor and party chief. During his time in the economically developed Zhejiang, Xi contributed to Zhejiang’s averaging growth rate of 14 percent, and was popular for his tough approach to corruption. In 2006, Xi replaced
Shanghai’s Party Chief, Chen Liangyu, after Chen’s scandal. The party chief position in Shanghai opened the opportunity for Xi to move to the top of China’s political pyramid.

In October 2007, Xi was included in the nine-member Politburo Standing Committee. In March 2008, Xi was elected as the Vice-President of the People’s Republic of China. His election ensured Xi’s candidacy as China’s next generation leader. Currently, Xi is also serving as Secretary of the Secretariat of the CPC and Vice Chairman of the Central Military Commission of the CPC. Xi is now confirmed as the next person in line waiting to succeed Hu Jintao in 2012.

Politically, Xi is seen as very careful and prudent, at least in public. (FlorCruz, 2010) Xi’s political behavior makes sense since his father was purged by Mao during the Cultural Revolution, and was put in prison for 16 years. (Ford, 2010) Like many other princeling politicians today, Xi’s privileged childhood life was taken away from him during the time of Cultural Revolution. Xi faced a lot of hardships growing up. He was sent to a poor village in Northern China to work for several years after his father was purged. (Ford, 2010) This unique experience may have led him to believe that supporting the existing political route rather than making bold reforms is the safest way to reach and stay at the top of the political pyramid.

Princeling political force is currently very strong in the CPC. Even though many have faced hardships during their childhood, they are currently beneficiaries of political power and significant economic privileges. Xi’s enrollment at the prestigious Tsinghua University and his quick rise as the governor and party chief to the rich provinces of Fujian and Zhejiang was the result of his princeling privileges.
With Xi’s connection, his daughter is currently enrolled at Harvard University. Given the huge political and economic benefits hold by princeling politicians today, they have little incentive to change the current political system. Therefore, stability of the CPC is within the best interest of princeling politicians.

Xi’s tough stance on stability is evident during his visit to Lhasa, Tibet in July 2011. Ongoing tension and frequent unrest between Tibet and China can be traced back to 1950, when the PLA defeated the Tibetan army and incorporated Tibet as an autonomous region of China. Stability in Tibet became one of the CPC’s key political objectives. During his visit to Tibet, Xi insisted on improving stability in Tibet.

In one of his speeches in Tibet, Xi commented on the need to improve “[armed forces] capabilities in taking preventive actions and handling emergency situations.” (Rediff, 2011) Based on his comment, Xi takes a very tough stance on political repression to guarantee China’s sovereignty and probably will use greater political repression in China than any of his predecessors since Deng Xiaoping.

Xi’s repressive behavior is rooted in his ideal of a strong state power as the basis for liberation and wealth. In his speech at the Central Party School in early September of 2011, Xi stated that “two overriding objectives – the struggle for both national independence and popular liberation, which is to say the realization of both state power and popular wealth – have always been closely related. The former has always been the basis of the latter.” (Gilley, 2011) His speech represents a trace of Mao’s ideology.

Bruce Gilley, an assistant professor of political science at Portland State University and
the author of “The Right to Rule: How States Win and Lose Legitimacy,” compared Xi’s political characteristic to Mao in his article “Meet the New Mao.” (Gilley, 2011)

Even though Xi will likely be more repressive politically, it is likely that Xi will continue with economic progress based on his past track record at Fujian and Zhejiang provinces. Also, as observed by the BBC’s China analyst Shirong Chen, “But [Xi] appears down-to-earth and pro-business, promoting foreign direct investment and demanding party officials drop their political jargon in favour of straight talking.” (Chen, 2010)

Based on Xi’s childhood and adult political experiences, it is very likely that Xi will follow Hu Jintao’s footsteps in promoting greater economic growth while adopting an even greater use of military action if necessary. This combination of continued economic advancement and enhanced political suppression is necessary to maintain the CPC’s stability, and is also what is required for the upcoming princeling leader, Xi, to survive, while preserving the privileges of his princeling faction in the CPC.

7. Conclusion
The result of Mao’s centrally planned economy was the backwardness of China’s economic development. After Deng came to power as the de facto leader, his market promoting institutions provide the incentive for provincial/local government officials and private individuals to engage in market exchange, which in turn facilitated rapid growth in China through the 1980s. Given Deng’s economic blueprint, Jiang Zemin continued the market-oriented process in the 1990s. Jiang promoted greater economic privatization
and reduced the size of the SOEs, which transformed China into a real market economy with rapid economic growth.

When Hu Jintao came to power in 2003, he took a backward step and adopted a more cautious approach to China’s economic development. Hu focused on strengthening the existing SOEs and creating a harmonious society through increased media censorship. Even though China’s economy continued to grow at a rapid rate under Hu, the growth is not likely to sustain given Hu’s reform methodology.

If Hu, as a technocrat, was unwilling to push China’s economic reform to the next level, how will the next generation princeling leader Xi Jinping approach China’s reforms? Will he continue with Hu’s approach and bring China further backward, or will he be bold enough to bring greater freedom to the people of China? The answer to this question can be known only after Xi has successfully succeeded Hu in 2012. However, based on what is known of Xi, i.e. his upbringing, his political background as a princeling politician, and his characteristic as the Vice President of the People’s Republic of China, Xi’s pro-Mao political ideology is unlikely to be compatible with greater economic freedom in China.
1. Introduction

China’s rapid economic development over the past three decades was initiated by Deng Xiaoping’s market-oriented economic reforms. This reform momentum continued under Jiang Zemin through privatization of smaller-sized State-Owned Enterprises (SOEs) and the growth of the private sector. China’s economy continued to grow rapidly under Hu Jintao, even though a large share of the GDP growth was generated by strengthening existing SOEs. Between 1979 and 2009, China achieved a compound annual GDP growth rate of 9.9 percent. (CEIBS, 2010)

If GDP growth is an indicator of economic freedom, then it is possible to conclude that China has gradually moved toward greater economic freedom over the last 30 years with its near double-digit compound annual GDP growth rate. Thus, in the future, enhanced economic freedom in China requires continued rapid economic growth. The survey Index of Economic Freedom (IEF), developed by The Heritage Foundation and The Wall Street Journal, finds a strong positive correlation between economic freedom and average income per person. (Index of Economic Freedom, 2011) Similar correlation has been found in the survey, Economic Freedom of the World (EFW), developed by Fraser Institute. (Economic Freedom of the World, 2011)
However, economic freedom is a complex concept with many factors involved. According to the survey IEF, economic freedom is categorized into business freedom, trade freedom, monetary freedom, fiscal freedom, investment freedom, financial freedom, freedom from corruption, and labor freedom. (Index of Economic Freedom, 2011) Therefore, having a precise understanding of the concept of economic freedom is necessary, in order to identify the true development of economic freedom in China.

Having a comprehensive understanding of the meaning of economic freedom would allow a more precise judgment on China’s economic development, i.e., whether economic freedom in China is improving or deteriorating over time, from Deng Xiaoping, to Jiang Zemin, to Hu Jintao. More specifically, this chapter examines major economic events and reforms in China since 1989, such as the Tiananmen Square Protest in 1989, the reform of SOEs under Deng Xiaoping in the 1980s, and the reform of SOEs under Jiang Zemin in the 1990s. These economic events and reforms are used as tipping points to empirically evaluate their impacts on economic freedom in China.

2. Defining the Concept of Economic Freedom
   Since economic freedom is a broad concept and there is no universally accepted definition of economic freedom, a good starting point is to define the term. According to the survey Economic Freedom of the World, key ingredients of economic freedom include personal choice over collective choice, voluntary exchange coordinated by markets, freedom to enter and compete in markets, and protection of persons and their property from aggression by others. (Economic Freedom of the World, 2011) Given the four key ingredients of economic freedom, the next logical step is to comprehend these
four key ingredients of economic freedom and why they are essential to economic freedom.

In an economically free society, individuals should be able to make personal choice or decisions given their budget constraints. Personal choice should be distinguished from collective choice or decision making. Collective choice is making decisions on behalf of others. A perfect example of collective choice is China’s commune system under Chairman Mao, in which all farming activities were decided collectively by the commune leaders. Personal choice on the other hand, requires privately financed system such as a market in which people are able to make individual decisions. (Robinson, 1996)

If personal choice is permissible under a privately financed system, then individuals in this system should have the freedom to use the resources they possess, and the freedom to choose how to spend their income. The freedom to use resources and the freedom to choose how much income to spend are mutually inclusive. One cannot exist without the other. As stated by Nobel Prize laureate Milton Friedman, personal choice is "the freedom to choose how to use our income: how much to spend on ourselves and on what items; how much to save and in what form; how much to give away and to whom.” (Friedman, 1990)

The freedom to make individual economic choice over collective choice implies that people are engaged in voluntary exchanges, usually coordinated by a market. What does “voluntary” mean in the context of exchange? According to Merriam-Webster, one
definition of voluntary is “proceeding from one’s own choice or consent,” and another definition of voluntary is “unconstrained by interference.” (Merriam-Webster, 2011)

If voluntary exchange requires one’s own choice or consent and should not be constrained by interference, then involuntary exchange is contributed to force or coercive action. China’s commune system was coercive in nature. People were forced to contribute their resources to the commune, from stored food to cooking utensils. Even private cooking was abandoned involuntarily. Therefore, voluntary exchange must be free from coercion.

The freedom to make voluntary exchange without coercion is the foundation for individuals to enter and compete in markets freely. Only with voluntary exchange as a precondition could individuals be free to enter and compete in markets. Under involuntary exchange, individuals would be forced either to enter into a market, or would be prohibited from entering into a market. Without the freedom to enter or exit a market, individuals cannot compete freely, which would result in a monopolistic market situation.

To induce market competition, voluntary exchange coordinated by markets, and to be able to make personal choice in markets requires a well-established property rights structure. A well-established property rights structure protects people and their property from aggression by others. Without a well-established property rights structure, none of the four key ingredients described above would apply. Therefore, economic freedom would not exist in a society without a well-established property rights structure.

According to economist Armen Alchian, “a property right is the exclusive authority to determine how a resource is used, whether that resource is owned by
government or by individuals.” (Alchian, 1993) To distinguish resources owned by a government and resources owned by an individual, Alchian further explains the differences between the two types of ownerships. Resource owned by a government “has to operate under a set of rules determined…by executive agencies it has charged with that role.” Private property rights are determined by “the exclusive right to the services of the resources” and “the right to delegate, rent, or sell any portion of the rights by exchange or gift at whatever price the owner determines.” (Alchian, 1993)

If property rights affect the four key ingredients of economic freedom identified in the survey of Economic Freedom of the World, then a well-established, property rights structured world leads to greater economic freedom. If economic freedom is highly correlated with average income per person, or a people’s standard of living, then a well-established property rights structure also would lead to higher standard of living in a society. But how do property rights affect people’s standard of living?

Alchian and Demsetz pointed out the importance of property rights to resolve conflicts over the use of scarce resources. (Alchian and Demsetz, 1973) A well-established property rights structure has four attributes, including the right to use the good, the right to earn income from the good, the right to transfer the good to others, and the right to the enforcement of property rights. (Eggertsson, 1990)

Under a socialist society, ownership of properties belongs to all the people living in the society. Individuals cannot decide for themselves how scarce resources are used. Therefore, the state takes the role as the ultimate decision maker on the allocation of the society’s scarce resources for production and distribution. On the one hand, individual
economic actors lack the incentive to promote the efficient use of scarce resources without individual ownership of properties. On the other hand, the state lacks local knowledge and information to distribute scarce resources and wealth efficiently. Inefficient use of scarce resources in the society leads to lower productive efficiency, which leads to lower growth and standard of living.

Under a capitalist society, ownership of properties belongs to the individuals living in the society. Since individuals in a capitalist society can decide for themselves how to allocate scarce resources, and reap the fruit of their decisions, they, therefore, have the incentive to allocate scarce resources efficiently. Efficient use of scarce resources in the society leads to higher productive efficiency, which would lead to higher growth and standard of living.

3. **Tiananmen Square Protests – 1989**

3.1. **Background of the Tiananmen Square Protests**

The Tiananmen Square protests provided a perfect case study of people’s enhanced awareness of freedom when economic conditions improve. Even though these protests failed to transform China from a communist country to a democratic country, greater economic freedom did occur many years after the incident. However, this enhanced economic freedom in China under Jiang Zemin still lagged behind by the standard of developed countries, but it was a step forward relative to China’s past.

The Tiananmen Square protests of 1989 were the result of the accumulation of economic, political, and social problems since Deng’s market-oriented economic reforms in 1978. These problems led to a series of demonstrations organized by students and
intellectuals at and near Tiananmen Square in Beijing beginning on April 15\textsuperscript{th}, 1989. The protests were triggered by the death of former General Secretary of the CPC Hu Yaobang, who was purged for his liberal economic and political ideals. (Pan, 2008)

The gathering, to mourn the death of Hu Yaobang, soon turned into protests, with more than 100,000 people gathered at Tiananmen Square, protesting against the central government of China, demanding faster economic reforms and greater liberalization. Participants were non-violent. They demanded a negotiation with the central government. The protests lasted seven weeks from April 15\textsuperscript{th}. Even though the media focused their reports on the protests at Tiananmen Square, these protests amplified into many large cities throughout China. (Miles, 2009) Therefore, it is clear that awareness of freedom increased nationwide, and not just among the students and intellectuals in Beijing.

Due to the severity of these protests, Premier Li Peng declared martial law on May 20\textsuperscript{th}. Since the central government was unwilling make the negotiation, a crackdown was ordered, on June 4\textsuperscript{th} 1989, near Tiananmen Square. Hundreds of people were killed during the crackdown and thousands were injured. Several high-ranking reformist politicians were arrested, including General Secretary of the CPC Zhao Ziyang.

After the June 4\textsuperscript{th} 1989 crackdown, the official Chinese figure reported the number of casualties at 241 dead and 7,000 wounded. (Liang, 2002) Nicholas D. Kristof, winner of two Pulitzer Prizes, wrote in The New York Times that “The true number of deaths will probably never be known, and it is possible that thousands of people were killed without leaving evidence behind. But based on the evidence that is now available, it seems plausible that about fifty soldiers and policemen were killed, along with 400 to
800 civilians.” (Kristof, 1989) There are many other reports on the number of casualties during the crackdown; even though they are inconsistent, the severity of the crackdown is obvious.

It is generally accepted that economic reform was the main driving force of the Tiananmen Square protests. Wang Hui, a professor at Tsinghua University in Beijing, stated that “these changes (the economic reforms) were the catalyst for the 1989 social mobilization.” (Wang, 2003) Similar sentiment was also expressed by Barry Naughton, the So Kwanlok Chair of Chinese International Affairs at the University of California, San Diego. Naughton stated that “economic causes were an important part of the social crisis leading up to the Tiananmen debacle” and he asserted that the social crisis leading up to the Tiananmen Square protests were created by deteriorating cyclical economic conditions. (Naughton, 2007)

Since China’s economic reforms were deepened many years after the Tiananmen Square protests under Jiang, the Tiananmen Square protests is considered an important tipping point to China’s economic development. By examining China’s economic reforms from 1978 to 1989 and statistical variables relevant to these reforms, it is used here to determine their impact on Chinese citizens’ increased awareness of freedom, which led to the Tiananmen Square protests. Further analysis of the institutional changes made after the tipping point of the Tiananmen Square protests can determine whether economic freedom improved or worsened after the protest.

For this analysis, the number of participants in major cities in China is calculated from The Tiananmen Papers. The Tiananmen Papers is a collection of hundreds of
internal government documents secretly smuggled out of China. They were compiled under the pseudonym Zhang Liang, and the English version was translated and edited by Andrew J. Nathan, professor of political science at Columbia University, Perry Link, Emeritus Professor of East Asian Studies at Princeton University, and Orville Schell, Arthus Ross Director of the Center on U.S.-China Relations at the Asia Society in New York.

Also, statistical data is utilized, from the China Statistical Yearbooks, for the periods of 1978 to 1989 at the provincial level, such as domestic investment of the collective and the private sectors, foreign direct investment (FDI), and the level of education in China. Using these economic variables, their effects on the Tiananmen Square protests are examined.

3.2. Economic Analysis of the Tiananmen Square Protests
The catalyst for the Tiananmen Square protests was rooted in the economic reforms since 1978. Beginning in 1979, the people’s commune was replaced by the contract-responsibility system in agriculture production. This reform liberalized the state’s control over the use of land and labor in the rural areas, turning farmers into profit-seeking actors, without abandoning the state’s control of land.

By the end of 1983, 98 percent of rural households in China signed contracts with the local authorities to become land owners. The change in the property rights structure contributed to the rural output growth of 48.64 percent from 1978 to 1984. (Lin, 1994) Through land contracts, the productivity in agriculture increased, which reduced the number of farmers needed over time.
The Tiananmen Papers showed no evidence that farmers in large numbers participated in these protests. This information matches other media reports and scholarly publications. Since these protests were organized only in major cities throughout the country, farmer participants in large scale was not likely. There may have been farmer participants in support of the student protestors in small scale, but they were not the driving force in this movement.

Another way to eliminate the unlikelihood of farmer protestors was to think about the nature of the initial agricultural reform of 1979. With the agricultural reform, farmers were direct economic beneficiaries. From the commune system to the contract-responsibility system, farmers experienced greater economic freedom. At the same time, increased agricultural productivity increased their standard of living as well. Therefore, the contract-responsibility system did not directly influence the student movement of 1989. However, an indirect effect was likely through its impact on the collective and private sectors of the economy.

| Table 1 Total Investment in Fixed Assets (Billion Yuan) |
|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Total          | 910.9          | 1430.06        | 1832.87        | 2543.2         | 3120.6         | 3791.7         | 4753.8         | 4410.4         |
| State-owned Units | 745.9         | 957.96         | 1185.18        | 1680.5         | 2079.4         | 2448.8         | 3020           | 2808.1         |
| Total Share    | 81.9%          | 67.0%          | 64.7%          | 66.1%          | 66.6%          | 64.6%          | 63.5%          | 63.7%          |
| Collective-owned Units | 46           | 156.33         | 238.69         | 327.5          | 391.8          | 547            | 711.7          | 570            |
| Total Share    | 5.0%           | 10.9%          | 13.0%          | 12.9%          | 12.6%          | 14.4%          | 15.0%          | 12.9%          |
| Individuals Economy | 119          | 321.77         | 409            | 535.2          | 649.4          | 795.9          | 1022.1         | 1032.3         |
| Total Share    | 13.1%          | 22.5%          | 22.3%          | 21.0%          | 20.8%          | 21.0%          | 21.5%          | 23.4%          |

Increased agricultural productivity created labor surplus in the agricultural sector in the early to mid-1980s. These surplus laborers would then seek work in other sectors of the economy. Increased investment in fixed assets by the collective and the private sectors was a reflection of the sectorial shift in the 1980s. Table 1 shows the total investment in fixed assets. The investment share in the collective sector rose from 5% in 1980 to 15% in 1988, while the investment share in the private sector rose from 13.1% to 23.4%.

The growth of these two sectors was associated with widespread corruption in the local governments, particularly the collective sector. Through the introduction of the dual-track system, fiscal decentralization, and local governments’ control over property rights, local officials are motivated to promote local economic development. Jean Oi, William Haas Professor in Chinese Politics at Stanford University, pointed out that the economic system is “structured so that local officials have a double incentive to promote rural industry: growth allows them to benefit economically as individuals.” (Oi, 1992)

Through misallocation of the state’s economic and political resources, local officials were able to engage in illegal exchanges with the collective and private entrepreneurs for economic gains. The practice of “tanwu shouhui” involved local officials exploiting their political positions to extract bribes, while the practice of “nuoyong gongkuan” involved local officials’ use of public resources for personal benefits. (Manion, 1997)

Widespread corruption in China was one of the leading factors that led to the student protests at Tiananmen. Since the growth of the collective and the private sectors
go hand-in-hand with the level of corruption, provinces with higher growth in these two sectors would cause higher level of corruption. Thus, provinces with higher levels of corruption would cause higher levels of protests measured by the number of participating student protestors.

Table 2 Number of Protestors in 1989 by City/Province & Total Investment in Fixed Assets in 1988 by Sector

| Province    | City          | Number of Protesters (Peak) | Guangdong | Shandong | Jiangsu | Zhejiang | Hebei | Sichuan | Shanghai | Hubei | Hunan | Liaoning | Henan | Beijing | Anhui | Shanxi | Yunnan | Fujian | Tianjing | Jiangxi | Guangxi | Heilongjiang | Jilin | Xinjiang | Shaanxi | Inner Mongolia | Gansu | Guangzhou | Qinghai | Hainan | Ningxia | Tibet |
|-------------|---------------|----------------------------|-----------|----------|---------|----------|-------|---------|----------|-------|-------|----------|-------|---------|-------|--------|--------|--------|---------|---------|---------|-----------|-------|---------|--------|--------|--------|-------|
Table 2 compares total investment in fixed assets in 1988 by region to the peak number of protesting participants by city in May and June of 1989. Total investment in fixed assets is an implicit indicator of the size of different sectors of the economy. Provinces with bigger size collective and private sectors have higher level of investment in these sectors. Provinces are listed based on investment in fixed assets of the collective sector, from largest investment to smallest investment. The peak numbers of protesting participants in The Tiananmen Paper were rough estimates. For some cities, the number of participants was not reported in these internal reports because they were too small to be counted.

By comparing the data in Table 2, most provinces with higher level of total investment in fixed assets also have higher number of protesting participants. On the contrary, most provinces with lower level of total investment in fixed assets did not have protesting participants recorded. There are a few provinces that are outliers, with a negative correlation between investment in fixed assets and the number of protesting participants. In Lanzhou city of Gansu province, for example, the large scale of participants was not driven by investment in fixed assets.

Shijiazhuang city of Hebei province is another outlier where the high level of investment in fixed assets did not cause a high level of participants. Therefore, there must be other factors in the economy that drives the level of protesting participants. Due to the
accuracy issue of the dataset as a result of the scale and the severity of these protests, the
correlation between the two variables cannot be perfectly matched between provinces.
However, the positive correlation between total investments in fixed assets and the peak
number of protesting participants in general is clear.

Besides the development of the collective and private sectors, China opened its
door to the outside world in order to attract foreign direct investment (FDI). By
establishing special economic zones (SEZs) in the coastal cities, the flow of FDI enabled
China to obtain financial capital, advanced technologies, and management skills. The
early FDI came in the form of joint ventures. Over time, the solely foreign-owned
enterprises became the primary form of foreign investment. FDI became increasingly
important to facilitate the growth of market-oriented economy in China.

FDI could be another leading factor which facilitated the Tiananmen Square
protests. Through increased level of FDI, people in China increased their interaction with
foreigners. Interacting with the outside world would help to enhance people’s awareness
of greater personal choices and freedom, particularly when interacting with democratic
countries.

<table>
<thead>
<tr>
<th>Province</th>
<th>City</th>
<th>Number of Protesters (Peak)</th>
<th>Foreign Direct Investment &amp; Other Investment by Region 1988 (10,000 US Dollar)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guangdong</td>
<td>Guangzhou</td>
<td>400,000</td>
<td>Guangdong 125,106</td>
</tr>
<tr>
<td>Beijing</td>
<td>Beijing</td>
<td>100,000</td>
<td>Beijing 50,318</td>
</tr>
<tr>
<td>Shanghai</td>
<td>Shanghai</td>
<td>30,000</td>
<td>Shanghai 23,317</td>
</tr>
<tr>
<td>Fujian</td>
<td>Fuzhou</td>
<td>50,000</td>
<td>Fujian 14,547</td>
</tr>
<tr>
<td>Liaoning</td>
<td>Shenyang</td>
<td>30,000</td>
<td>Liaoning 13,055</td>
</tr>
</tbody>
</table>
Table 3 compares FDI and other foreign investments by region in 1988 to the peak number of protesting participants by city in May and June of 1989. Foreign investment is an implicit indicator of enhanced awareness of personal choice over collective choice and freedom. Provinces with higher level of foreign investment should also have a higher level of awareness of personal choice and freedom. Provinces are

<table>
<thead>
<tr>
<th>Province</th>
<th>City</th>
<th>FDI 1988</th>
<th>Protesting Participants May-June 1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jiangsu</td>
<td>Nanjing</td>
<td>20,000</td>
<td>12,551</td>
</tr>
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<td></td>
<td>11,744</td>
</tr>
<tr>
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<td>Xian</td>
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</tr>
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<td>Jinan</td>
<td>10,000</td>
<td>8,972</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>Harbin</td>
<td>20,000</td>
<td>6,934</td>
</tr>
<tr>
<td>Henan</td>
<td></td>
<td></td>
<td>6,422</td>
</tr>
<tr>
<td>Tianjin</td>
<td>Tianjin</td>
<td>30,000</td>
<td>6,115</td>
</tr>
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<td>Hangzhou</td>
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<td>4,379</td>
</tr>
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<td>Yunnan</td>
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<td></td>
<td>4,227</td>
</tr>
<tr>
<td>Sichuan</td>
<td>Chengdu</td>
<td>40,000</td>
<td>4,027</td>
</tr>
<tr>
<td>Anhui</td>
<td>Hefei</td>
<td>30,000</td>
<td>2,791</td>
</tr>
<tr>
<td>Hubei</td>
<td>Wuhan</td>
<td>20,000</td>
<td>2,231</td>
</tr>
<tr>
<td>Guangxi</td>
<td></td>
<td></td>
<td>2,087</td>
</tr>
<tr>
<td>Hebei</td>
<td>Shijiazhuang</td>
<td>8,000</td>
<td>1,910</td>
</tr>
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<td>Hunan</td>
<td>Changsha</td>
<td>10,000</td>
<td>1,288</td>
</tr>
<tr>
<td>Guizhou</td>
<td>Guiyang</td>
<td>3,000</td>
<td>983</td>
</tr>
<tr>
<td>Jilin</td>
<td>Changchun</td>
<td>20,000</td>
<td>970</td>
</tr>
<tr>
<td>Jiangxi</td>
<td></td>
<td></td>
<td>891</td>
</tr>
<tr>
<td>Shanxi</td>
<td>Taiyuan</td>
<td>10,000</td>
<td>652</td>
</tr>
<tr>
<td>Inner Mongolia</td>
<td></td>
<td></td>
<td>639</td>
</tr>
<tr>
<td>Xinjiang</td>
<td></td>
<td></td>
<td>504</td>
</tr>
<tr>
<td>Qinghai</td>
<td></td>
<td></td>
<td>270</td>
</tr>
<tr>
<td>Gansu</td>
<td>Lanzhou</td>
<td>100,000</td>
<td>235</td>
</tr>
<tr>
<td>Ningxia</td>
<td></td>
<td></td>
<td>32</td>
</tr>
<tr>
<td>Tibet</td>
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<td></td>
<td>3</td>
</tr>
</tbody>
</table>

listed based on foreign investment, from the largest investment to the smallest investment. The peak number of protesting participants is the same as in Table 2.

By comparing the data in Table 3, most provinces with a higher level of foreign investment also have a higher number of protesting participants. On the contrary, most provinces with a lower level of foreign investment did not have protesting participants recorded. There are a few provinces that are outliers, with negative correlation between foreign investment and the number of protesting participants. Both Lanzhou city of Gansu province and Shijiazhang city of Hebei province are again obvious outliers, with negative correlation between foreign investment and the number of protesting participants. However, in general, the positive correlation between foreign investments and the peak number of protesting participants is clear.

Interacting with the outside world also increased the number of students studying abroad, usually in more developed countries. Students receiving better education while learning the culture of those more developed countries would be more aware of personal choice and freedom. Once they returned to China, not only would they demand greater personal choice and freedom for themselves, but they also would influence the people around them to greater awareness of personal choice and freedom, particularly in the institutions of higher education. Therefore, increased number of students studying abroad would facilitate the Tiananmen Square protests.

<table>
<thead>
<tr>
<th>Table 4 Students Studying Abroad &amp; Return Students (person)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>277</td>
</tr>
</tbody>
</table>
From Table 4, the number of students studying abroad increased over time from 277 in 1976 to 3329 in 1989. Studying abroad should have a gradual impact on students’ awareness to personal choice and freedom. What is intriguing is the sudden change in the number of students studying abroad over a short period of time. In looking at the period from 1977 to 1978, there was a rapid increase in the number of students studying abroad, and that number continued to increase rapidly in the following year.

The significance of this period was the Beijing Spring democratic movement led by students in 1977 and 1978, similar to the Tiananmen Square protests. Therefore the Beijing Spring movement was correlated with rapid increase in the number of students studying abroad. If these two variables are correlated, then a rapid change should be seen in the number of students studying abroad in the late 1980s, leading up to the student protests.

Looking at the data, there was no rapid increase in the number of students studying abroad in the late 1980s, and the number was actually decreasing during that

### Table 4: Students Studying Abroad and Returned Students from Abroad

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Abroad</strong></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Growth Rate</strong></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Returned Students</strong></td>
<td>189</td>
<td>270</td>
<td>248</td>
<td>231</td>
<td>162</td>
<td>1143</td>
<td>2116</td>
</tr>
<tr>
<td><strong>Growth Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Students Studying</strong></td>
<td>2633</td>
<td>3073</td>
<td>4888</td>
<td>4676</td>
<td>4703</td>
<td>3786</td>
<td>3329</td>
</tr>
<tr>
<td><strong>Growth Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Returned Students</strong></td>
<td>2303</td>
<td>2920</td>
<td>1424</td>
<td>1388</td>
<td>1605</td>
<td>3000</td>
<td>1753</td>
</tr>
<tr>
<td><strong>Growth Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

period. However, there was a rapid increase in the number of returned students studying from abroad. The number of returned students increased from 1605 in 1987 to 3000 in 1988. Therefore, the data shows a positive correlation between students studying abroad and student protests in 1989 at the macro-level.

In addition to the impact of economic reforms on the student protests, the level of higher education in China should have a direct influence on the number of protesting participants. Higher education in general affects students’ awareness to freedom and government misconducts. Therefore, provinces with greater number of students should have higher number of student protestors.

<table>
<thead>
<tr>
<th>Province</th>
<th>City</th>
<th>Number of Protesters (Peak)</th>
<th>Student Enrollment in Higher Education by Region 1988 (10,000 person)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jiangsu</td>
<td>Nanjing</td>
<td>20,000</td>
<td>Jiangsu 147,705</td>
</tr>
<tr>
<td>Beijing</td>
<td>Beijing</td>
<td>100,000</td>
<td>Beijing 143,546</td>
</tr>
<tr>
<td>Sichuan</td>
<td>Chengdu</td>
<td>40,000</td>
<td>Sichuan 140,760</td>
</tr>
<tr>
<td>Hubei</td>
<td>Wuhan</td>
<td>20,000</td>
<td>Hubei 130,048</td>
</tr>
<tr>
<td>Shanghai</td>
<td>Shanghai</td>
<td>30,000</td>
<td>Shanghai 128,163</td>
</tr>
<tr>
<td>Liaoning</td>
<td>Shenyang</td>
<td>30,000</td>
<td>Liaoning 120,510</td>
</tr>
<tr>
<td>Shandong</td>
<td>Jinan</td>
<td>10,000</td>
<td>Shandong 101,281</td>
</tr>
<tr>
<td>Shaanxi</td>
<td>Xian</td>
<td>20,000</td>
<td>Shaanxi 97,955</td>
</tr>
<tr>
<td>Guangdong</td>
<td>Guangzhou</td>
<td>400,000</td>
<td>Guangdong 97,224</td>
</tr>
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<td>Hunan</td>
<td>Changsha</td>
<td>10,000</td>
<td>Hunan 87,297</td>
</tr>
<tr>
<td>Henan</td>
<td></td>
<td></td>
<td>Henan 79,882</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>Harbin</td>
<td>20,000</td>
<td>Heilongjiang 78,879</td>
</tr>
<tr>
<td>Hebei</td>
<td>Shijiazhuang</td>
<td>8,000</td>
<td>Hebei 73,047</td>
</tr>
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<td>Jilin</td>
<td>Changchun</td>
<td>20,000</td>
<td>Jilin 72,933</td>
</tr>
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<td>Anhui</td>
<td>Hefei</td>
<td>30,000</td>
<td>Anhui 63,130</td>
</tr>
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<td>Zhejiang</td>
<td>Hangzhou</td>
<td>100,000</td>
<td>Zhejiang 60,419</td>
</tr>
<tr>
<td>Province</td>
<td>City</td>
<td>Enrollment</td>
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<tr>
<td>---------------</td>
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</tr>
<tr>
<td>Fujian</td>
<td>Fuzhou</td>
<td>50,000</td>
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<td>Tianjing</td>
<td>Tianjin</td>
<td>30,000</td>
<td></td>
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<tr>
<td>Jiangxi</td>
<td>Taiyuan</td>
<td>10,000</td>
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<td>Shanxi</td>
<td>Taiyuan</td>
<td>10,000</td>
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<tr>
<td>Yunnan</td>
<td>Yunnan</td>
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<td>Guangxi</td>
<td>Lanzhou</td>
<td>100,000</td>
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<td>Inner Mongolia</td>
<td>Inner Mongolia</td>
<td>32,634</td>
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<td>Xinjiang</td>
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<td>Guizhou</td>
<td>Guiyang</td>
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<td>Hainan</td>
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<td>Ningxia</td>
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<td>Qinghai</td>
<td>Qinghai</td>
<td>7,012</td>
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<tr>
<td>Tibet</td>
<td>Tibet</td>
<td>1,736</td>
<td></td>
</tr>
</tbody>
</table>


Table 5 compares student enrollment in higher education by region in 1988 to the peak number of protesting participants by city in May and June of 1989. Higher education is a direct indicator of enhanced awareness to freedom and government misconducts. In a province, a higher level of student enrollment in higher education should increase students’ awareness to freedom. Provinces are listed based on student enrollment in higher education, from largest enrollment to smallest enrollment. The peak number of protesting participants is the same as in Table 2.

By comparing the data in Table 5, most provinces with a higher level of student enrollment also had a higher number of protesting participants. On the contrary, most provinces with a lower level of foreign investment did not have protesting participants recorded. There are a few provinces that are outliers, with a negative correlation between
student enrollment in higher education and the number of protesting participants. The positive correlation between student enrollment in higher education and the peak number of protesting participants in general is clear.


4.1. Introduction

Soon after the crackdown on June 4th 1989, Deng Xiaoping stepped down as the de facto leader. Under Jiang Zemin, the new leader of China, economic reforms were put on hold. At this point in time, the central leaders were more cautious about further economic reforms and had considered economic retreat through recollectivization of agriculture and recentralization of investment and financial powers. (Qian, 1999) GDP growth in China slowed down to 4.4 percent in 1989 and 3.9 percent in 1990.

To reverse the economic downturn, Deng made his famous southern tour in January 1992. During his visit, Deng made the remark of faster paced economic reforms. Jiang was reluctant to adopt further economic reforms at first. However, as a transitional figure without a strong political base, Jiang was left without any choices but to follow Deng’s footsteps. As a result, CPC’s retreat from economic reforms from 1989 to 1991 was again revived in 1992.

Several major economic reforms took place after Deng’s southern tour, starting with opening up additional special economic zones (SEZs), improving managerial autonomy in SOEs, abolishing plan allocated foreign exchange, to the introduction of a clear distinction between central and local taxes. Among these economic reforms, reform
of SOEs was the most significant breakthroughs in the 1990s due to the scale and production capacity of SOEs in China’s economy.

### 4.2. History of State-Owned Enterprises

The emergence of the state sector in China in the late 1950s was the result of Chairman Mao’s ideology of building a new China, following the socialist tradition of Soviet Union. The key attribute of the state sector is SOEs run by the central government. SOEs were formed according to the Lenin model of State Syndicate, a super enterprise monopolized by the state. The foundation of SOEs was formed by merging all nonagricultural industries in the cities into large state run enterprises and converting all the existing laborers into government employees.

The primary task of SOEs was to achieve centrally planned production of industrial goods set by the state, which prohibited individual decision making freedom through trade and privatized resource allocation. Through SOEs, the central government was able to control the productive resources nationwide and redistribute them based on the decision making of the central leaders. This top-down process in production and resource allocation created asymmetric information in the society, where the information flow between the top and bottom was restricted as a two way problem.

The control of production and resource allocation by the central government restricted economic information flow from the top to the bottom in the society in order to gain political control. Consequently, blocking the information flow also prevented local information flow from the bottom to the top, resulting in the state’s inefficient use of production and resource allocation.
In addition to the inefficiency from production and resource allocation, SOEs also guaranteed their employees with job security, called the “iron bowl,” and free social services such as housing, health insurance, and social security. Also, the administrative and management functions of SOEs were integrated into the Communist Party of China (CPC), and the managers were also cadres of the Communist Party. The highly inefficient nature of SOEs resulted in the slow growth of China’s economy during Chairman Mao’s era.

To reduce the inefficient nature of SOEs and to promote growth in China, Deng Xiaoping introduced incentive based management system among SOEs. This system rewarded the managers of SOEs based on their performance in term of production. Managers were rewarded based on the amount of production by their SOEs. Once an SOE met the production quota set by the state, additional production could then be sold to other firms at market price. Profit from additional production sold at the market price would be retained by the SOE, and a percentage of this profit would be rewarded to the manager of this SOE.

Even with the new incentive structure introduced to SOEs under Deng, the organizational function of SOEs was inefficient and the issue of soft budget constraint was not solved. Therefore, the performance of SOEs were still lacking far behind the collective-owned enterprises and individual enterprises.

Since SOEs were an integral part of the state and the CPC, they were not independent economic entities. Prior to the 1990s, SOEs functioned more like government entities and the managers of SOEs were regarded as cadres of the CPC. (Wu,
A major part of the decision making of SOEs involved serving the political motives of the party, such as controlling economic resources and achieving four modernizations. Therefore, SOEs were not profit-seeking oriented firms.

Due to the unique political and social functions of SOEs, they had little or no budget constraint, which was defined by Janos Kornai as “soft budget constraint.” If SOEs experienced financial problems, “the state will bail it out with tax allowances, credits at preferential terms, financial grants, taking over the losses, or permitting prices increases.” (Kornai, 1980) Given the political nature and limited budget constraint faced by SOEs, debt accumulation in the late 1980s and early 1990s became their major problem.

Heavy debt-burden left the state with no choice but to make more fundamental institutional changes to SOEs. The fundamental problem with SOEs was ownership dominance by the state and lack of enforcement on decision making at the management level. To resolve these issues, corporatization took place in the late 1990s.

Corporatization was a process of transforming SOEs into modern corporations by separating the administrative and managerial functions of SOEs, or transforming SOEs into sharing holding corporations.

Since the state took incremental steps in reforming SOEs in the 1980s and 1990s, examining the effectiveness of these reforms is imperative. What was the impact of these reforms on SOEs in terms of increasing their competitiveness against non-state enterprises, reducing their loss, and increasing their profit? If these reforms were
successful, what was the fundamental economic reasoning that led to the success? If not, what was the fundamental economic reasoning that led to the failure?

To tackle the questions above, the individual effects of these incremental reforms, starting from “power-delegating and profit-sharing” to corporatization of SOEs, is analyzed. Statistical data is drawn from China Industry Economy Statistical Yearbook to make empirical analysis on the impact of SOE reforms in the 1980s and 1990s.

4.3. Reforms of State-Owned Enterprises: Power-Delegating and Profit-Sharing
Starting from 1978 to the early 1990s, three incremental reforms were initialed under the slogan “power-delegating and profit-sharing,” starting from “transferring enterprises to governments at lower levels,” “expanding enterprise autonomy,” to “enterprise contracting system.” The primary objective of these reforms was to establish an independent management to “buy assets, upgrade technology, develop new products…determine an incentive system for employees…link personal benefits of the insiders to the enterprise’s performance.” (Wu, 2005)

The first aspect of the reform was “transferring enterprises to governments at lower levels” to reduce centralized control over inefficient SOEs. Centralized control was a major cause of low efficiency in SOEs. The state usually lacked local information necessary to make good decision for SOEs and often made decisions out of its own best interest. Since the success of locally controlled SOEs would contribute to local economic growth, transferring the control of SOEs from the state to the local governments would help to align the interests between local governments and locally controlled SOEs.
By delegating power from the state to the local governments, local governments would be able to manage local SOEs according to local economic conditions and adapt to changes more quickly. With enhanced local information, local governments would be able to make more efficient managerial decisions in terms of production, employment, finances, and loans.

The second aspect of SOE reform was “expanding enterprise autonomy.” In general, the goal of expanding enterprise autonomy was to reduce government control, therefore, increasing the business decision making of SOEs. This aspect of the reform was considered more as an extension of “transferring enterprises to governments at lower levels.” Even with transferring from central control to local control, the issue of greater autonomous decision making by SOEs is not addressed. Therefore, expanding autonomy of SOEs resolved this issue.

In fact, “expanding enterprise autonomy” has been instituted since 1978 and it was modified over time. The initial autonomous structure was established as profit-retention, which was the original form of profit-sharing. SOEs were given the permission to retain a percentage of additional profits for any additional goods sold to other firms after meeting the state’s quota. In 1983, the portion of the profits remitted to the state was also modified. Profits that were once remitted to the state finance department were converted to income tax payment instead. In 1994, income tax payment by SOEs was standardized, in which all SOEs would pay their income tax at a uniform rate.

The third aspect of SOE reform was “enterprise contracting system.” In essence, enterprise contracting system promoted managerial responsibility in order to reduce
government control of SOEs. This was achieved through a contract established between two parties, the management of the SOE, and the government organization in charge of the SOE. Through this contract, both parties reached an agreement whereby the manager agreed to ensure the government organization a fixed amount of profit. Any additional profit was then awarded to the SOE.

4.4. **Economic Analysis of Power-Delegating and Profit-Sharing**

The goal of SOE reforms in the 1980s was to turn SOEs into profit-seeking enterprises. The economic reform titled “power-delegating and profit-sharing” was aimed at introducing the necessary incentive structure to motivate individual SOEs and their managers to engage in profit-seeking behaviors. In general, the more output SOEs produced beyond the state’s quota, the higher the profit SOEs could retain. The profit could be used to pay bonuses to the managers and employees.

The question to ask is whether “power-delegating and profit-sharing” achieved its intended purpose at the macro-level? Table 6 shows the gross industrial output value by ownership. The gross industrial output of SOEs did in fact grow over time from 3916 billion yuan to 17824 billion yuan in 1992. However, the output growth of SOEs cannot explain whether “power-delegating and profit-sharing” was effective at making SOEs more competitive than other sectors of the economy.

Output growth of SOEs could be the result of market-oriented economic reforms in general, which means that all sectors of the economy were growing rapidly, including the state sector, collective sector, private sector, and other non-state sectors. If general
economic reforms caused the increased output growth of SOEs, then “power-delegating and profit-sharing” failed to make SOEs more competitive or efficient.

To figure out whether SOEs became more competitive or efficient through SOE reforms in the 1980s, looking at output growth of SOEs relative to other sectors of the economy, instead of output in absolute term, is necessary. Table 7 shows the gross industrial output value of ownership as percentage to total gross industrial output value. The share of industrial output value for SOEs was approximately 76 percent of the total gross industrial output value in 1980. The share of industrial output value for SOEs was reduced over time to approximately 52 percent in 1992.

This data shows that SOEs were becoming less dominate or competitive over time. The major driving force behind the reduced dominance of SOEs was the output growth of the collective-owned enterprises. The industrial output value for collective-owned enterprises was 12,135 billion yuan in 1992, which is close to the industrial output of 17,824 billion yuan by SOEs.

Table 6 Gross Industrial Output Value by Ownership (In Billion Yuan)

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<tbody>
<tr>
<td>State-owned Enterprises</td>
<td>3,915.60</td>
<td>4,326.00</td>
<td>5,262.70</td>
<td>6,971.12</td>
<td>10,351.28</td>
<td>13,063.75</td>
<td>17,824.15</td>
</tr>
<tr>
<td>Collective-owned Enterprises</td>
<td>1,231.36</td>
<td>1,442.42</td>
<td>2,263.09</td>
<td>3,751.54</td>
<td>6,587.49</td>
<td>8,522.73</td>
<td>12,135.00</td>
</tr>
<tr>
<td>Private Enterprises</td>
<td>0.81</td>
<td>3.40</td>
<td>14.80</td>
<td>308.54</td>
<td>790.49</td>
<td>1,290.30</td>
<td>2,006.00</td>
</tr>
<tr>
<td>Other Non-state Enterprises</td>
<td>24.49</td>
<td>39.40</td>
<td>76.70</td>
<td>163.06</td>
<td>495.32</td>
<td>1,047.56</td>
<td>2,633.57</td>
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Table 7 Gross Industrial Output Value by Ownership as Percentage To Total Gross Industrial Output Value

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<tbody>
<tr>
<td>State-owned Enterprises</td>
<td>75.97%</td>
<td>74.44%</td>
<td>69.09%</td>
<td>62.27%</td>
<td>56.80%</td>
<td>54.06%</td>
<td>51.52%</td>
</tr>
<tr>
<td>Collective-owned Enterprises</td>
<td>23.54%</td>
<td>24.82%</td>
<td>29.71%</td>
<td>33.51%</td>
<td>36.15%</td>
<td>35.62%</td>
<td>35.07%</td>
</tr>
<tr>
<td>Private Enterprises</td>
<td>0.02%</td>
<td>0.06%</td>
<td>0.19%</td>
<td>2.76%</td>
<td>4.34%</td>
<td>5.39%</td>
<td>5.80%</td>
</tr>
<tr>
<td>Other Non-state Enterprises</td>
<td>0.47%</td>
<td>0.68%</td>
<td>1.01%</td>
<td>1.46%</td>
<td>2.72%</td>
<td>4.38%</td>
<td>7.61%</td>
</tr>
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</table>


Given the fact that SOEs were losing their dominance on industrial output, whether “power-delegating and profit-sharing” was effective, or not, is still not explained. There is no implication that SOE reforms in the 1980s were not effective simply because the industrial output share of SOEs were reduced over time. There are two conceivable explanations that led to the reduced industrial output share of SOEs. One possible explanation is that “power-delegating and profit-sharing” had little effect on the efficiency and competitiveness of the SOEs; therefore, collective-owned enterprises with higher efficiency were able to slowly catch up to the industrial output level of SOEs.

Another possible explanation is that “power-delegating and profit-sharing” was effective at improving the efficiency of SOEs. However, industrial output of the non-state sectors of the economy was also increasing as a result of Deng’s market-oriented economic reforms. Since non-state sectors were less developed than the state sector in the 1980s, enterprises in the non-state sectors were initially able to increase their industrial output at a faster rate than SOEs, until they become more developed.

Given these two plausible explanations, additional data must be examined in order to determine which explanation was the more realistic description of SOEs in the late
1980s and early 1990s. Did SOE reforms in the 1980s actually make SOEs more efficient? Table 8 shows the total industrial loss by loss-making industrial enterprises. Loss-making industrial enterprises were broken down into two components, the state-owned industrial enterprises and all industrial enterprises. All industrial enterprises also include the state-owned industrial enterprises.

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<tbody>
<tr>
<td>34.3</td>
<td>47.6</td>
<td>26.6</td>
<td>54.5</td>
<td>81.9</td>
<td>348.8</td>
<td>369.3</td>
<td></td>
</tr>
</tbody>
</table>

| All Industrial Enterprises       | 38.8 | 55.8 | 34.2 | 72.4 | 106.6| 453.7| 469.1|

| Share of State Enterprises to All Enterprises | 88.4% | 85.3% | 77.8% | 75.3% | 76.8% | 76.9% | 78.7% |


The total industrial loss by all industrial enterprises rose significantly from 38.8 billion yuan in 1980 to 469.1 billion yuan in 1992, while the industrial loss by state-owned industrial enterprises rose from 34.3 billion yuan in 1980 to 369.3 billion yuan in 1992. Therefore, significant increase in the total industrial loss from 1980 to 1992 was driven by state-owned industrial enterprises. One implication from this data is that “power-sharing and profit-delegating” was not effective at improving the efficiency of SOEs; otherwise, state-owned industrial enterprises would not be the driving force behind the total industrial loss in the 1980s and early 1990s.

Examining this data more closely, the share of the total industrial loss contributed by state-owned industrial enterprises was in fact reduced in the early 1980s, from 85.3
percent in 1982 to 77.8 percent in 1984. From 1984 to 1992, the share stayed approximately constant. From this reduced share of the total industrial loss contributed by state-owned industrial enterprises in the early 1980s, the point can be argued that the initial part of “power-delegating and profit-sharing” did improve the efficiency of SOEs temporarily to a small degree.

One possible contributing factor for the enhanced efficiency of SOEs was the introduction of market prices by the state. This institutional change may have altered the incentive behavior of the managers of SOEs. However, this beneficial effect did not last beyond the mid-1980s.

Based on the data, “power-delegating and profit-sharing” had little effect on improving the efficiency and competitiveness of SOEs. Why did SOE reforms fail to achieve its goals in the 1980s and early 1990s? To answer this question, a closer look is needed at the institutional arrangements of SOEs, specifically the property rights structure of SOEs and agency problems faced by the state in managing SOEs; and, more specifically, at individual reforms independently, from “transferring enterprises to governments at lower levels,” “expanding enterprise autonomy,” to “enterprise contracting system.”

The property rights structure is critical in determining the success of SOEs, because it helps to resolve conflicts over the use of scarce resources. (Alchian and Demsetz, 1973) Property rights define the right to ownership of the property and “are an institutional way of recognizing people’s command over assets.” (Chiu and Lewis, 2006)
Since property rights of SOEs were publicly owned and the economy was centrally planned, then the assets of SOEs were controlled by the central government prior to Deng’s market-oriented economic reforms. With public ownership and control rights by the central government, managers of SOEs had little incentive to make their SOEs profitable. Therefore, the intended purpose of SOE reforms under “power-delegating and profit-sharing” was to provide managers with the incentive to turn SOEs from plan-based enterprises into performance-based enterprises.

One way to increase the incentive of the managers was to reduce centralized control over SOEs. Therefore, “transferring enterprises to governments at lower levels” was used to transfer the control right of SOEs from the central government to the local governments. The central government believed that local governments, with better local economic information, would control their local SOEs more efficiently.

However, transferring control rights from the central government to the local governments did not enhance the incentive of the managers. Whether the control is centralized or localized, it has little to do with the incentive structure of the managers. Since the ownership of SOEs still belongs to the public, local governments had little economic gain from promoting the performance of SOEs.

Another way to enhance the performance and efficiency of SOEs was to introduce greater autonomy into SOEs, and it was experimented under the reform of “expanding enterprise autonomy.” A variation of this reform was under the name “enterprise contracting system.” This reform tackles directly the sluggish performance of SOEs by
allowing managers more autonomous decision making, rather than strictly following the central plan.

In addition, profit-retention was included in this reform, which allowed SOEs to retain additional profits once they met the state’s production quota. By combining these two features, the reform guaranteed the production quota contributed to the state and allowed managers to make profit-seeking decision making, after meeting the production quota.

On the surface, this reform makes sense because it provides managers with the incentive to engage in profit-seeking economic activities. However, two problems arose under this new arrangement: the lack of a proper enforcement mechanism, and the lack of a well-established property rights discussed earlier with transferring the control right of SOEs. These two problems go hand-in-hand.

The enforcement problem arose when one party could not properly enforce the work of the second party. This concept applies to expanding the autonomy of SOEs and profit-retention. In theory, profit-retention motivates managers to engage in profit-seeking activities. However, profit-seeking motives differ when short-term motive is compared with long-term motive. Managers of SOEs are not the owners of SOEs, so they do not receive residual claimants.

Another way to put this is that managers were not guaranteed long-term profits. Therefore, they were more likely to engage in short-term profits-seeking behavior so that they could maximize their personal gain in the short term. Maximizing short-term profits are usually achieved at the cost of long-term profits.
4.5. **Reforms of State-Owned Enterprises: Corporatization**

When the reforms under “power-delegating and profit-sharing” failed to reduce the debt-burden problem of SOEs, the state realized that more innovation must be applied to SOEs in order to reduce their losses and increase their profits. Since the introduction of incentive mechanism and managerial autonomy did not provide the necessary ingredients to resolve the inefficient nature of SOEs, changing the institutional structure of SOEs then became the key objective of the state.

During the 3rd Plenary Session of the 14th Central Committee of the Communist Party of China (CCCPC) in November 1993, Jiang proposed to establish a modern enterprise system to invigorate SOEs. The reforms of SOEs led by Jiang Zemin were aimed at dealing with the debt issue by establishing property rights, redefining power and responsibility, separating enterprise from government, and creating a scientific management system.

In November 1994, the State Council declared to reform SOEs via corporatization. The initial corporatization involved only 100 SOEs as an experiment before nationwide corporatization took place. Detailed laws and requirements for corporatization of SOEs were adopted at the Fourth Plenary Session of the 15th CCCPC in 1999.

Two clear objectives were set under the corporatization reform in 1999. The first objective was to establish checks and balances between the owner (state) and the manager of SOEs through the newly created corporate governance structure. The second objective was to reinforce the first objective using multiple equity-holding entities and allowing non-state equity investment. (Wu, 2005)
To achieve these two objectives, three methods were introduced to corporatize SOEs. The first was to separate the administrative function and enterprise function of SOEs; the second was to breakdown monopolized SOEs into competitive SOEs; and the third was to allow IPO on domestic and foreign securities markets through asset restructuring.

Prior to the separation of the administrative function and the enterprise function, SOEs were economic units and administrative organs, which served economic, political, and social functions. Under the new institution, the administrative function was transferred to the State Economic and Trade Commission, a state asset management commission to perform the function of ownership of SOEs. As a result of this reform, national level SOEs were no longer responsible for their administrative function.

Monopolized SOEs were used under a planned economy to achieve economy of scale. For example, the Ministry of the Petroleum Industry monopolized the petroleum industry prior to 1983, managing both upstream and downstream businesses. In 1983, upstream businesses of the Ministry of the Petroleum Industry were reorganized into China Petroleum Corporation (SINOPEC). In 1988, downstream businesses of the Ministry of the Petroleum Industry were reorganized into the China National Petroleum Corporation (CNPC). In addition to these two organizations, the China National Offshore Oil Corporation (CNOOC) was established in 1982. After the institutional reform of SOEs in 1998, competition among these three, major, national oil companies was allowed through investment and operation in each other’s territory.
Besides restructuring SOEs internally, external force was also utilized to increase the effectiveness of SOE reforms in 1998. To enhance the enforcement mechanism, IPO was introduced in SOEs. Through the separation of core assets and noncore assets of SOEs, shares of core assets were sold to the public through IPO, whereas noncore assets were kept in the original enterprises. This separation facilitates the inflow of financial resources through an external route, while reducing the financial burden of the state.

In order for SOEs to raise funds by issuing shares, two methods were employed. The first method was to sell shares internally to employees of SOEs. Selling shares to employees was the most convenient way to diversify the ownership of SOEs. The second method was to sell shares externally to public investors. Shareholding increased the diversification of share ownership and funding, and it also increased the transferability of rights of investors.

4.6. **Economic Analysis of Corporatization**

When SOE reforms under “power-delegating and profit-seeking” failed to improve the efficiency of the SOEs and to reduce the state’s debt-burden generated by the SOEs, the state was left with no choice but to make a fundamental institutional change. Corporatization of SOEs was a major breakthrough in the late 1990s to reduce government control over SOEs. Earlier SOE reforms failed precisely because the state took de facto control over the ownership of SOEs.

Corporatization was aimed at turning SOEs into modern enterprises with separation of enterprise from government, and well-defined property rights.
Economically speaking, modern enterprise structure would reduce agency problems caused by earlier SOE reforms; thus improve the efficiency and performance of SOEs.

To analyze the impact of corporatization on SOEs, gross industrial output value by ownership and in percentage share is represented in Table 9. The gross industrial output value grew steadily over time from 17,824 billion yuan in 1992 to 45,179 billion yuan in 2002. However, SOEs were outperformed by collective-owned enterprises from 1996 to 1998 in terms of gross industrial output value. Starting from 1998 to 2002, the combined industrial output value from private enterprises and other non-state enterprises also outperformed SOEs.

### Table 9 Gross Industrial Output Value by Ownership (In Billion Yuan) and Percentage Share

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<tbody>
<tr>
<td>State-owned Enterprises</td>
<td>17,824</td>
<td>26,201</td>
<td>36,173</td>
<td>33,621</td>
<td>40,554</td>
<td>45,179</td>
</tr>
<tr>
<td>% Share</td>
<td>(51.52%)</td>
<td>(37.34%)</td>
<td>(33.68%)</td>
<td>(26.47%)</td>
<td>(38.23%)</td>
<td>(32.58%)</td>
</tr>
<tr>
<td>Collective-owned Enterprises</td>
<td>12,135</td>
<td>26,473</td>
<td>39,232</td>
<td>45,730</td>
<td>11,908</td>
<td>9,619</td>
</tr>
<tr>
<td>% Share</td>
<td>(35.07%)</td>
<td>(37.72%)</td>
<td>(36.53%)</td>
<td>(36.01%)</td>
<td>(11.23%)</td>
<td>(6.94%)</td>
</tr>
<tr>
<td>Private Enterprises</td>
<td>2,006</td>
<td>7,082</td>
<td>15,420</td>
<td>20,372</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% Share</td>
<td>(5.80%)</td>
<td>(10.09%)</td>
<td>(14.36%)</td>
<td>(16.04%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Non-state Enterprises</td>
<td>2,634</td>
<td>10,421</td>
<td>16,582</td>
<td>27,270</td>
<td>53,609</td>
<td>83,886</td>
</tr>
<tr>
<td>% Share</td>
<td>(7.61%)</td>
<td>(14.85%)</td>
<td>(15.44%)</td>
<td>(21.47%)</td>
<td>(50.54%)</td>
<td>(60.49%)</td>
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Note: State-owned enterprises after 1997 also include state-holding enterprises.

Gross industrial output value is not the only determining factor to judge the performance of SOEs. There were other effects that affected the gross industrial output value around the time that corporatization was initiated. The first effect was privatization.
of SOEs under the slogan “grasping large enterprises and letting go of small enterprises.”

The second effect was the rapid growth of the non-state enterprises as a result of privatizing SOEs and more developed market economy in general.

Table 10 shows the number of industrial enterprises by ownership and percentage share. Through privatization, the number of SOEs was dramatically reduced from 113,800 in 1996 to 41,100 in 2002. The rapid growth of non-state sectors also sharply increased the industrial output by non-state enterprises. The combined effect from SOE privatization and the growth of non-state sectors had a significant effect on the reduced industrial output share of SOEs. Therefore, other measures must be analyzed to see the impact of corporatization on SOEs.

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</thead>
<tbody>
<tr>
<td>State-owned Enterprises</td>
<td>10.33</td>
<td>10.22</td>
<td>11.38</td>
<td>6.47</td>
<td>5.35</td>
<td>4.11</td>
</tr>
<tr>
<td>% Share</td>
<td>(20.6%)</td>
<td>(19.2%)</td>
<td>(19.7%)</td>
<td>(39.2%)</td>
<td>(32.8%)</td>
<td>(22.6%)</td>
</tr>
<tr>
<td>Collective-owned Enterprises</td>
<td>38.45</td>
<td>38.51</td>
<td>39.48</td>
<td>4.77</td>
<td>3.78</td>
<td>2.75</td>
</tr>
<tr>
<td>% Share</td>
<td>(76.6%)</td>
<td>(72.4%)</td>
<td>(68.2%)</td>
<td>(28.9%)</td>
<td>(23.2%)</td>
<td>(15.2%)</td>
</tr>
<tr>
<td>Other Non-state Enterprises</td>
<td>1.42</td>
<td>4.45</td>
<td>7.02</td>
<td>5.27</td>
<td>7.16</td>
<td>11.3</td>
</tr>
<tr>
<td>% Share</td>
<td>(2.8%)</td>
<td>(8.4%)</td>
<td>(12.1%)</td>
<td>(31.9%)</td>
<td>(44.0%)</td>
<td>(62.2%)</td>
</tr>
</tbody>
</table>

Note: State-owned enterprises after 1997 also include state-holding enterprises.

One of the methods to determine the change in performance of SOEs is to look at the loss generated by SOEs relative to their profit. Since the purpose of corporatization was to turn SOEs into profit-seeking enterprises and to reduce the debt-burden of the
state, then the loss generated by loss-making SOEs relative to the profit generated by profit-making SOEs would reduce if corporatization was successful.

Table 11 shows the total loss by loss-making industrial SOEs and net profit by profit-making industrial SOEs. Looking at the ratio of loss to net profit, the ratio dropped significantly from 69 percent in 1992 to 25 percent in 2002. Before concluding that the increased profit by profit-making SOEs and reduced loss by loss-making SOEs were contributed by corporatization, it is necessary to look at the composition of loss-making SOEs and profit-making SOEs.

<table>
<thead>
<tr>
<th>Table 11 Loss and Net Profit of State-owned Industrial Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Loss by Loss-making SOEs</td>
</tr>
<tr>
<td>Net Profit by Profit-making SOEs</td>
</tr>
<tr>
<td>Ratio of Loss to Net Profit in %</td>
</tr>
</tbody>
</table>


Table 12 shows the share of loss-making and profit-making industrial enterprises in percentage, including SOEs, collective-owned enterprises, private enterprises, joint enterprises, shareholding companies, and stock companies. The share of loss-making SOEs was 33.75 percent in 1996 and 36.36 in 2000, while the share of profit-making SOEs was 66.25 percent in 1996 and 63.64 percent in 2000. For all other enterprises besides SOEs, the share of loss-making and profit-making also stay stable from 1996 to 2000.
There were small fluctuations from 1996 to 2000, but they were not big enough to affect the outcome of this analysis. Data prior to 1996 was not available. Since there were no major SOE reforms from 1992 to 1995, small changes can be assumed in the share of loss-making and profit-making SOEs. These changes would not affect the outcome of this analysis.

Table 12 Share of Loss-making and Profit-making Industrial Enterprises in Percentage

<table>
<thead>
<tr>
<th></th>
<th>1996</th>
<th>1997</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State-owned Enterprises</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Loss-making Enterprises %</td>
<td>33.75%</td>
<td>38.22%</td>
<td>41.09%</td>
<td>36.36%</td>
</tr>
<tr>
<td>Share of Profit-making Enterprises %</td>
<td>66.25%</td>
<td>61.78%</td>
<td>58.91%</td>
<td>63.64%</td>
</tr>
<tr>
<td><strong>Collective-owned Enterprises</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Loss-making Enterprises %</td>
<td>17.96%</td>
<td>18.91%</td>
<td>17.29%</td>
<td>15.93%</td>
</tr>
<tr>
<td>Share of Profit-making Enterprises %</td>
<td>82.04%</td>
<td>81.09%</td>
<td>82.71%</td>
<td>84.07%</td>
</tr>
<tr>
<td><strong>Private Enterprises</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Loss-making Enterprises %</td>
<td>7.76%</td>
<td>13.32%</td>
<td>13.57%</td>
<td>12.59%</td>
</tr>
<tr>
<td>Share of Profit-making Enterprises %</td>
<td>92.24%</td>
<td>86.68%</td>
<td>86.43%</td>
<td>87.41%</td>
</tr>
<tr>
<td><strong>Joint Enterprises</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Loss-making Enterprises %</td>
<td>23.07%</td>
<td>24.87%</td>
<td>21.73%</td>
<td>19.44%</td>
</tr>
<tr>
<td>Share of Profit-making Enterprises %</td>
<td>76.93%</td>
<td>75.13%</td>
<td>78.27%</td>
<td>80.56%</td>
</tr>
<tr>
<td><strong>Shareholding Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Loss-making Enterprises %</td>
<td>20.64%</td>
<td>23.78%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Profit-making Enterprises %</td>
<td>79.36%</td>
<td>76.22%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Stock Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Loss-making Enterprises %</td>
<td></td>
<td></td>
<td>21.83%</td>
<td>19.25%</td>
</tr>
<tr>
<td>Share of Profit-making Enterprises %</td>
<td></td>
<td></td>
<td>78.17%</td>
<td>80.75%</td>
</tr>
</tbody>
</table>


Since the composition of loss-making and profit-making enterprises was kept steady over this period, the effect of composition change on the reduced ratio of loss to
net profit of SOEs can be eliminated. Therefore, to conclude, corporatization had a significant effect on the increased profit and reduced loss generated by SOEs.

There are two possible explanations for the improved profit generated by profit-making SOEs and reduced loss by loss-making SOEs in the late 1990s and early 2000s. With corporatization, the ownership of SOEs was diversified through IPO. The diversification of ownership either altered the incentives of the SOE managers or enhanced the discipline of managers, or a combination of both, which enhanced the profit-seeking behavior of SOE managers.

Looking at the data more closely, the initial implementation of corporatization had a negative effect on profit generated by SOEs. The ratio of loss to net profit spiked significantly around the time that corporatization began with 192 percent in 1996 and 219 percent in 1998 (Table 6). This temporary spike in the loss and reduction in profit was inevitable for SOEs during the beginning stage of corporatization. Thus, fundamental institutional change had a short-term negative impact on SOEs. This temporary loss was the tradeoff that SOEs had to face in order to gain long-term profit.

When determining the change in efficiency and performance of SOEs, relative change in comparison to collective-owned enterprises and non-state enterprises must also be taken into consideration. Even though, from the data above, a conclusion is drawn that SOEs performed better after corporatization, comparison is necessary of the relative performance among different sectors of the economy to determine the true success of corporatization.
Table 13 shows the loss and net profit of non-SOEs, including collective-owned and non-state industrial enterprises. The majority of non-state industrial enterprises were private enterprises, foreign-funded enterprises, and shareholding companies. Comparing the ratio of loss to net profit between SOEs and non-SOEs before and after the implementation of corporatization is important. If the ratio of loss to net profit between SOEs and non-SOEs shrinks after corporatization, then a conclusion can be made that the efficiency and performance of SOEs has improved as a result of corporatization.

**Table 13 Loss and Net Profit of Collective-owned and Non-state Industrial Enterprises**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Loss by Loss-making Enterprises</td>
<td>99.8</td>
<td>289.9</td>
<td>640.6</td>
<td>586.2</td>
<td>431.8</td>
<td>463.1</td>
</tr>
<tr>
<td>Net Profit by Profit-making Enterprises</td>
<td>437.3</td>
<td>967.8</td>
<td>1077.1</td>
<td>933</td>
<td>1985.2</td>
<td>3151.6</td>
</tr>
<tr>
<td>Ratio of Loss to Net Profit in %</td>
<td>23%</td>
<td>30%</td>
<td>59%</td>
<td>63%</td>
<td>22%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Note: State-owned enterprises after 1997 also include state-holding enterprises. Non-state industrial enterprises include private enterprises, foreign-funded enterprises, shareholding companies, and other non-state enterprises.

Prior to corporatization, the ratio of loss to net profit for SOEs was 69 percent in 1992 and 58 percent in 1994 (Table 11), while the ratio of loss to net profit for non-SOEs was 23 percent in 1992 and 30 percent in 1994 (Table 13). After corporation, the ratio of loss to net profit for SOEs was 29 percent in 2000 and 25 percent in 2002 (Table 11), while the ratio of loss to net profit for SOEs was 22 percent in 2000 and 15 percent in 2002 (Table 13).
In comparing the ratios on the loss to net profit before and after corporatization, the difference in the ratios between SOEs and non-SOEs has reduced significantly. Therefore, that the efficiency of SOEs improved significantly in the early 2000s, which means that corporatization was successful, can be concluded.

To ensure the comparability of loss and net profit between SOEs, non-SOEs, eliminating the compositional effect of non-SOEs, which is the change in the composition of loss-making non-SOEs and profit-making non-SOEs, is necessary. From the analysis above, the conclusion has been made that the composition of SOEs and non-SOEs stays stable from 1996 to 2000 (Table 12); therefore, any changes in loss and net profit of non-SOEs were not affected by the changes in the share of loss-making and profit-making non-SOEs.

However, if the performance of non-SOEs is set as the benchmark using the ratio of loss to net profit of 15 percent in 2002, then there is room for SOEs to improve their performance given their ratio of loss to profit of 25 percent in 2002. Since non-SOEs performed better than SOEs even after corporatization, then which one of these non-SOEs drives this performance differential needs to be determined. Is it the collective-owned enterprises or the non-state enterprises? To answer this question, it is necessary to compare the scale of collective-owned enterprises relative to non-state enterprises.

Table 14 shows the number of collective-owned and non-state industrial enterprises. The number of collective-owned enterprises was shrinking from 47,700 in 1998 to 27,500 in 2002, while the number of non-state enterprises was expanding from 52,700 in 1998 to 113,000 in 2002. Due to the change in the reporting method, starting in
1998, reporting from 1998 to 2002 measures only industrial enterprises with annual sales revenue exceeds 5 million yuan. This reporting change only measures the change in the large-sized enterprises, but not the overall scale change of the collective-owned and non-state enterprises. An alternative source is needed to measure the relative size of collective-owned and non-state enterprises over time.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Collective-owned</td>
<td>38.45</td>
<td>38.51</td>
<td>39.48</td>
<td>4.77</td>
<td>3.78</td>
<td>2.75</td>
</tr>
<tr>
<td>Non-state</td>
<td>1.42</td>
<td>4.45</td>
<td>7.02</td>
<td>5.27</td>
<td>7.16</td>
<td>11.3</td>
</tr>
</tbody>
</table>

Note: Since 1998, reporting only consists of industrial enterprises with annual sales revenue exceeds 5 million yuan.

Table 15 shows the number of industrial staff and workers in the collective-owned and non-state enterprises. The number of staff and workers in the collective-owned enterprises shrank sharply from 18,620,000 in 1992 to 3,830,000 in 2002, while the number of staff and workers in the non-state enterprises rose rapidly from 2,380,000 in 1992 to 18,000,000 in 2002. Therefore, the scale of collective-owned enterprises did decrease significantly in the 1990s, and they were mostly absorbed by the non-state enterprises.
Table 15: Number of Industrial Staff and Workers (10,000 person)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Collective-owned Enterprises</td>
<td>1862</td>
<td>1604</td>
<td>1429</td>
<td>802</td>
<td>563</td>
<td>383</td>
</tr>
<tr>
<td>Other Non-state Enterprises</td>
<td>238</td>
<td>607</td>
<td>743</td>
<td>1230</td>
<td>1443</td>
<td>1800</td>
</tr>
</tbody>
</table>

Sources:

This data concluded that the performance differential, in terms of reduced loss and increased profit, between SOEs and non-SOEs in the late 1990s and early 2000s, was driven by non-state enterprises. In this same period, collective-owned enterprises had little impact on the performance of non-SOEs due to its significant size reduction.

Since most of the employees of collective-owned enterprises were absorbed by non-state enterprises, it proved that non-state enterprises were more efficient than collective-owned enterprises. Collective enterprises that were once considered the driving force of China’s rapid economic growth in the 1980s were no longer significant in the late 1990s. Thus, non-state enterprises with better property rights structure outcompeted collective-owned enterprises.

Based on this empirical analysis, three conclusions are made regarding corporatization. First, SOEs did make significant performance enhancement in terms of reduced loss and increased profit after corporatization. Second, this performance enhancement made by SOEs was not enough to catch up with the performance of non-SOEs. Third, the performance of non-SOEs was mainly driven by non-state enterprises rather than collective-owned enterprises in the 1990s and early 2000s. Given these
conclusions, it is imperative to understand why the performance of SOEs still could not match the performance of non-state enterprises even after corporatization.

Through corporatization, the new institutional structure of SOEs allowed for diversified ownerships in SOEs. Even with diversified ownerships, SOEs still could not break out of the state’s control. Diversification of ownership through IPO only reduced the state’s control of SOEs, which meant that the state still had influence over SOEs. How much influence the state had over SOEs depends on the percentage share of ownership. The higher the percentage shares of ownership, the bigger the influence. After corporatization, major SOEs still had over 50 percentage ownership shares held by the state.

Free riding is another problem under this diversified ownership system. Through IPO, ownership shares of SOEs were spread out among numerous owners. Increased diversification of ownership also increased the difficulty of enforcement. Individual owners were less likely to take action to enforce the managers of SOEs, knowing that other owners would free ride.

The cost of enforcement by an individual owner would far exceed the benefit received by this owner because the benefit would be shared among all the owners. Under this free riding problem, the state was the only party who had the incentive to influence the behavior of the managers of SOEs. The political benefit the state received has to exceed the monetary cost in order for the state to actively engage in SOE intervention.
4.7. **Conclusion**

China’s rapid economic growth in the decades of 1980s to 1990s was attributed to the economic reforms led by Deng Xiaoping and Jiang Zemin. China’s economic success and its path to greater economic freedom were uneven. Gradual economic reforms under incomplete market institutions in the 1980s triggered major economic, political, and social problems, which led to the Tiananmen Square protests.

These student protests in 1989 pushed the momentum for greater economic freedom, which accelerated the speed and depth of China’s economic reforms, from incentive based reforms to institutional based reforms in the 1990s. The most significant of these institutional reforms in the 1990s was corporatization of SOEs.
CHAPTER 5: THE WELL-PAVED HIGH ROAD TO ECONOMIC FREEDOM, 2001 – 2012

1. Introduction

China’s market-oriented reforms since 1978 have made major progress toward greater economic freedom. This is evident by the rapid growth of the private sector and reduced share of the state sector through privatization of State-owned Enterprises (SOEs) in the 1990s. Even among those existing SOEs, the institution of corporatization in 1998 reduced the state’s control over SOEs.

However, China is still far from economically free because Chinese leaders made little progress toward the fundamental economic issue of private property rights. Without a well-established property rights, personal choice is still limited and voluntary exchange is likely to be disrupted by coercion. The combined effect is that the protection against individual property and freedom cannot be ensured.

During the reform periods of 1980s and 1990s, foreign involvement in China’s economy was one of the major driving forces to China’s greater economic freedom. In 2001, China’s WTO accession created additional economic and political constraint to the Chinese government while providing additional opportunity to China’s future economic development. This new level of economic interaction between the Chinese economy and the global economy will determine the continued road to economic freedom in China.
2. China’s Accession to the WTO: 2001
After fifteen years of negotiations, China was finally accepted as a member of the World Trade Organization (WTO) on December 11th, 2001. China’s accession to the WTO signifies a new era of China’s economic and trade integration with the global economy. As one of the biggest economies in the world, China’s international trade integration would have a lasting impact on the global economy. In return, this integration would benefit China in terms of sustained economic growth and increased economic freedom.

China’s engagement with international trade can be traced back to 1948, when the Republic of China was a founding member of General Agreement on Tariff and Trade (GATT). GATT was signed in 1947 as a multilateral agreement among joining members to regulate trade. More specifically, this agreement was used to reduce tariffs and trade barriers. GATT lasted from 1948 to 1993, and was replaced by the WTO in 1995.

After the Communist Party of China (CPC) drove the Kuomintang (KMT) out of mainland China, CPC under the leadership of Mao Zedong established the People’s Republic of China. Under the CPC, China adopted central economic planning and central control of all economic resources in the society, which resulted in China been excluded from GATT in 1950.

Since then, China, under the communist leadership, engaged in central economic planning and closed-door economic policies. After 38 years of central planning and closed-door policies, market-oriented reforms were initiated in 1978, when China’s leadership changed hands, from Mao Zedong to Deng Xiaoping. Deng’s pragmatic
approach to market-oriented economic reforms led to the reopening of China’s economy in the world.

Following the success of export-oriented countries of Hong Kong, Singapore, Taiwan, and South Korea in East Asia, China realized the importance of trade interaction with the outside world. When Deng became the de facto leader of China, he pointed out the importance of open door policy to China’s economic development that “One important reason for China’s backwardness after the industrial revolution in Western countries was its closed-door policy…. The experience of the past thirty or so years has demonstrated that a closed-door policy would hinder construction and inhibit development.” Deng further elaborated that an open door policy “enables us to make use of capital from foreign countries and of their advanced technology and experience in business management.” (Deng, 1978)

Under Deng’s leadership, special economic zones (SEZs) were established in the 1980s in the effort to integrate China’s economy into the world economy. The initial SEZs were set up in 1980 in the coastal cities of Shenzhen, Zhuhai, Shantou, and Xiamen. After successful experimentation with these four SEZs, China further opened its door in 1984 by setting up additional fourteen economic zones in the coastal cities of Dalian, Qinhuaingdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai.

Besides establishing economic zones, the People’s Republic of China secured a seat on the United Nations Interim Commission for the International Trade Organization (ICITO) in April 1980. In 1984, China joined GATT’s Multi-Fibre Arrangement (MFA)
and signed the arrangement regarding International Trade in Textiles. By signing the arrangement on textiles, China’s export on textiles was potentially restricted by industrialized countries in case of market disruption. (Jacobson and Oksenberg, 1990)

In 1986, China re-applied to become a member of GATT. However, the June 4th 1989 Tiananmen Square crackdown prevented China from becoming a member of GATT in the near future. As a result of the crackdown, China’s reputation throughout the west was damaged, which slowed down China’s interaction with those nations. The World Bank and many foreign governments engaged in political condemnation by suspending foreign loans in China, while FDI commitments were cancelled. (Kelley and Shenkar, 1993)

The effort to promote an open door policy continued under Jiang Zemin several years after the Tiananmen Square crackdown. Two years after the crackdown, Deng made his famous southern tour in 1992, in which he stressed the importance of continued economic and openness reforms. Under Deng’s influence, Jiang continued and deepened market-oriented economic reforms. Not only did Jiang push for corporatization and privatization of SOEs, he also made an additional effort to integrate China into the global economy.

According to the former Canadian Prime Minister Jean Chretien (Xinhua News, 2001), Jiang strengthened China’s economic status abroad by establishing bilateral relations with the United States and countries whose trade is largely connected with the United States. In 1998, China negotiated bilateral trade agreements with 12 countries, including Australia, Japan, New Zealand, the Republic of Korea, and Singapore among
others. In 1999, China signed a bilateral trade agreement with the United States, which legitimized China’s status as a major player in international trade.

After fifteen years of negotiation, on December 11th, 2001, China officially became a member of the WTO. During these fifteen years of negotiation, China slowly reduced government control and intervention on trade, foreign investment, and foreign exchange. Prior to understanding the impact of WTO accession on China’s economy after 2001, it is imperative to understand the trade policies adopted by the Chinese government since 1978, and policy changes made by the Chinese government during its fifteen years in preparation for the WTO accession.

The economic policy of trade barrier is used to restrict imports through tariffs, quotas, anti-dumping legislations, and subsidies. Tariffs or taxes are imposed to increase the cost to importers, which reduces the quantity of imported goods. Quotas directly restrict the quantity of imported goods, which is similar to the effect of tariffs. Anti-dumping legislation is a law used to prevent foreigners from dumping cheaper goods, which would reduce the competitiveness of domestic goods. Subsidies are payments given to domestic firms that are otherwise not able to compete against imported goods.

These barriers are used by the domestic government to protect domestic businesses and workers from foreign competition. In the initial stage of China’s opening up to the outside world in the 1980s, China’s trade barriers were particularly strong in order to protect its infant industries. High import duties were imposed on goods produced in China and lower import duties were imposed on manufactured goods. (Bhalla and Qiu, 2004) In the 1980s, the average unweighted tariff rate in China was over 40 percent.
In order to become a member of GATT and to attract foreign capital and technology, China started to slowly reduce trade barriers in 1986 in preparation for the WTO entry. Table 16 shows tariff reductions in China between 1982 and 2001. Starting in 1982, the average unweighted tariff rate was 56 percent. Between 1986 and 1991, tariff rates on 81 out of 6,300 tariff lines were reduced to the range of 30 to 85 percent. On January 1st, 1992, the average unweighted tariff rate was 42.5 percent and it was reduced to 39.3 percent on 3371 tariff lines or duty codes by the end of 1992. By the end of 1993, tariff rate was reduced to 36.4 percent on 2898 tariff lines.

<table>
<thead>
<tr>
<th>Year</th>
<th>Unweighted Average Tariff Rates (%)</th>
<th>Adjusted Tariff Lines</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>56</td>
<td>81 tariff lines out of 6300</td>
</tr>
<tr>
<td>1986-1991</td>
<td>30-85</td>
<td>The Third &quot;Tariff Rates Rule&quot;</td>
</tr>
<tr>
<td>Jan 1, 1992</td>
<td>42.5</td>
<td>3371 tariff lines</td>
</tr>
<tr>
<td>Dec 31, 1992</td>
<td>39.3</td>
<td>2898 tariff lines</td>
</tr>
<tr>
<td>Dec 31, 1993</td>
<td>36.4</td>
<td>282 tariff lines and Automobiles</td>
</tr>
<tr>
<td>Jan 1, 1994</td>
<td>35.9</td>
<td>282 tariff lines and Automobiles</td>
</tr>
<tr>
<td>Jan 1, 1995</td>
<td>35.6</td>
<td>19 tariff lines in Tobacco, Liquor, Tape, and Mobile</td>
</tr>
<tr>
<td>Apr 1, 1996</td>
<td>23.4</td>
<td>4997 tariff lines</td>
</tr>
<tr>
<td>Oct 1, 1997</td>
<td>17</td>
<td>4874 tariff lines</td>
</tr>
<tr>
<td>1999</td>
<td>0.2-11</td>
<td>1014 tariff lines in textiles, toys, and forestry</td>
</tr>
<tr>
<td>2001</td>
<td>15.3</td>
<td>3462 tariff lines</td>
</tr>
</tbody>
</table>

On January 1st, 1994, tariff rate was reduced to 35.9 on 282 tariff lines and automobiles. On January 1st, 1995, tariff rate was reduced to 35.6 percent through the reduction of import tariff on cars, tobaccos, liquor, magnetic tapes, middle automobiles, etc. On April 1st, 1996, tariff rate was reduced to 23.4 percent on 4994 tariff lines, and this rate was further reduced to 17 percent on 4874 tariff lines on October 1st, 1997.

In 1999, tariff rate was reduced between 0.2 to 11 percent on 1014 tariff lines in textiles, toys, and forestry. In 2001, tariff rate was reduced to 15.3 percent on 3462 tariff lines. However, 15.3 percent tariff rate in China was much higher compared the 6 percent average tariff rate of WTO members. (OECD, 2002)

In becoming a member of WTO on December 11th, 2001, China agreed to further reduce tariff rates in different sectors of the economy in the years ahead. China was committed to complete the reduction or elimination of tariffs by the end of 2004. In the agricultural sector, China also agreed to reduce its average tariff rate from 18.9 percent to 15 percent, with the range from 0 to 65 percent tariff rates. In the industrial sector, the average tariff rate would be reduced from 14.8 percent to 8.9 percent, with the range from 0 to 47 percent tariff rates. (OECD, 2002)

Non-tariff barriers in China were also strongly imposed, including import licensing, quotas, and restricting trade rights to a limited number of companies. Among these barriers, import barrier is the most important in the 1990s, followed by state and designated trading, and then quota restrictions. In 1996, import barrier accounted for 18.5 percent of import, state and designated trading accounted for 18.3 percent of import, and quota restrictions accounted for 7.3 percent of import. (World Bank, 1997)
The number of non-tariff barriers had reduced or was eliminated over time in the 1990s. Table 17 shows the non-tariff barriers reductions in China between 1992 and 2001. In 1992, the number of licensed export commodities was reduced from 212 to 183 and import licenses on 16 categories were eliminated. Subsequently in the next year, import licenses for another 9 categories of 283 kinds of commodities were eliminated on December 31, 1993. In May 1994, the Chinese government stopped issuing mandatory plans for imports and exports, while import licenses and quotas for 195 kinds of commodities were cancelled. Additional import licenses for 120 kinds of commodities were removed in the next year.

### Table 17 Non-Tariff Barriers Reductions in China (1992-2001)

<table>
<thead>
<tr>
<th>Year</th>
<th>Reductions</th>
</tr>
</thead>
</table>
| 1992 | - Lowered the number of license export commodities from 212 to 183.  
- Removed import license for 16 categories. |
| 1993 | - Eliminated import license for another 9 Categories of 283 kinds of commodities including steel, medicine, civil aircraft, BW TV set. |
| 1994 | - Stopped issuing mandatory plans for imports and exports.  
- Canceled the import licenses and quotas for 195 kinds of commodities. |
| 1995 | - Eliminating import licenses for 120 kinds of commodities. |
| 1996 | - Cut the number of remaining quotas by 30 percent.  
- Reduction of import licensing requirements to 35 commodities. |
| 1997 | - Reduction of import licenses to 8.4 percent of total import value. |
| 1999 | - Reduction of import licenses to 4 percent of the total. |
| 2000 | - All non-tariff barriers accounted for 33 percent of imports. |
| 2001 | - Elimination of quota restrictions on automobiles. |

In April 1996, the Chinese government continued to eliminate the number of remaining quotas by 30 percent, while reducing import licenses to only 35 commodity categories. In 1997, import licenses reduction continued to 8.4 percent of total import value, and this value was further reduced to 4 percent of total import value in 1999. In 2000, all non-tariff barriers were accounted for 33 percent of imports. In 2001, quota restrictions on automobiles were eliminated.

Exchange rate can also be manipulated to provide indirect protection to domestic businesses. Exchange rate manipulation is used by the domestic government in the foreign exchange market, usually to lower the value of its currency in order to increase the cost of imports and lower the cost of exports. In 1980, China had one official exchange rate and RMB was valued at 1.50 yuan per US dollar. This exchange rate was overvalued to restricted export growth and to promoted import of capital goods. With little trade interaction, protection of domestic businesses was not needed.

When China began to interact with the outside world in the early 1980s, a series of exchange rate reforms were taken in order to earn foreign exchange. In 1981, the state implemented an internal exchange rate used to settle trade accounts under the policy of Regulations Concerning the Issues of Increasing Foreign Exchange Income Through the Development of External Trade. Between 1986 and 1994, three types of exchange rates were used simultaneously. The official rate was used to peg against the US dollar, the swap rate was occasionally adjusted by the central bank, and the effective exchange rate used by the exporters.
Since the exchange rate was overvalued in the early 1980s, China faced trade deficit throughout the 1980s. Trade deficit in China grew from 1.9 billion US dollars in 1980 to 14.9 billion US dollars in 1985. To reverse trade deficit, the Chinese government adjusted the official exchange rate from 2.93 yuan per US dollar in 1985 to 5.76 yuan in 1993. Table 18 shows the RMB exchange rates between 1985 and 2001. The devaluation of RMB reduced China’s trade deficit to 6.6 billion US dollars in 1989, and then turned China’s trade balance into surplus in most years in the 1990s.

As trade activities increased over time, higher demand for foreign exchange led to the unification of the official rate and the swap market rate in 1994. With one unified exchange rate, China continued to peg RMB against the US dollar, and the Chinese government set the rate at 8.62 yuan per US dollar. Between 1994 and 2001, the
exchange rate was kept stable with slight adjustment and the rate was 8.27 yuan per US dollar in 2001.

Besides a fixed exchange rate, the state also controlled the borrowing and lending of capital abroad. Under this control system, government approval was needed for banks and corporations to borrow or lend capital abroad. Also, authorized foreign exchange banks were designated to handle foreign exchange transactions and the restriction on the purchase of foreign exchange was enacted. The purchase of foreign exchange was permitted only to firms whose businesses involved transactions in foreign exchange.

To attract foreign capital, modern technology, and management skills, China adopted tax incentives that would attract foreign investment. Tax incentives include tax holidays, concessionary rates, and exemptions from import and export duties. The corporate income tax is generally lower in SEZs, which was 15 percent for joint venture enterprises and wholly foreign-owned enterprises.

In addition, the state provided a tax holiday of two profit-making years to these enterprises at reduction rates between 20 to 50 percent, and 50 percent tax reduction for another two years. Profits that were reinvested by these enterprises in the SEZs were exempted from income tax. Income tax exemption of up to 5 years was given to enterprises on high-technology related foreign investment. (Grub and Lin, 1991)

The state also reduced control on other regulations. Foreign-funded enterprises were given greater access to energy and transportation. Foreign participation in property and port development, power generation, and retailing were permitted. In addition, joint venture enterprises were allowed to sell their goods in the domestic market.
Initially, foreign-funded enterprises were only allowed to do business in SEZs, but this regulation was reduced in 1986, which enabled them to establish businesses in other parts of China. (OECD, 2002) Additional reduction in foreign investment regulations were implemented in the mid-1990s. The sectors of transportation, communications, insurance, and other service industries slowly opened up in 1995 to encourage additional foreign investment. In 1996, special tax treatments to foreign-funded firms were banned in order to offer equal treatment to domestic and foreign enterprises.

Upon becoming a member of the WTO on December 11th, 2001, China signed the Protocol on the Accession of the People’s Republic of China, an agreement which addressed the terms and conditions for China’s accession to the WTO. This agreement provided a detailed list of trade terms and conditions that China committed to pursue, which can be categorized into economic issues, trade issues, legal issues, and institutional issues. (Bhalla and Qiu, 2004)

Economic issues addressed price control, export taxes, subsidies, and import restriction. According to the Protocol, China must further reduce and eventually eliminate price controls, multi-tier pricing system, export taxes, subsidies, import licenses, quotas, and tariffs. These restrictions were aimed at constraining unfair trade advantages taken by the Chinese government while inducing China to rely more on natural market forces.

Trade issues were aimed at promoting free trade, and involved the elimination of special trade agreements, foreign exchange balancing requirements, local content and export performance requirements. China must allow the right to trade by all enterprises in
all goods, except those permitted under state trading, and provide full information on the pricing mechanisms for exporting goods.

Legal procedures must be adopted to maintain fair trade in China. Under the Transparency Clause, all laws and regulations regarding trade in China must be disclosed to all WTO members upon request. Official journals must be published frequently by the Chinese government on all the laws and regulations regarding trade.

Institutional provisions were made to prevent unfair trade. To prevent enormous export of Chinese goods, the provision of Transitional Product-specific Safeguard Mechanism was made. To ensure China’s implementation of the Protocol, the provision of Transitional Review Mechanism was made. Under the provision of Equal or Non-discriminatory Treatment, China was required to provide equal treatment for domestic and foreign enterprises in the allocation of goods and services for production and the distribution of import and export licenses.

Since China’s accession to the WTO, China’s economic growth continued to soar. According to the annual GDP growth rate data calculated by the World Bank (World Bank, 2011), China’s average GDP growth rate between 2002 and 2010 was 10.73 percent. China’s total GDP had reached 11.29 trillion US dollars in 2011, which is ranked by The World Factbook as the world’s third largest economy after the European Union and United States. (The World Factbook, 2012)

Significant increase in international trade after WTO accession is a major driving force to China’s growth. The World Factbook ranked China as the number one exporting country and number three importing country in the world in 2011. (The World Factbook,
Therefore, China’s membership to the WTO had a major impact on China’s rapid economic growth over the past decade.


Prior to China’s market-oriented reforms in 1978, China under Mao Zedong had little trade interaction with the world economy. China’s share in world trade was 1.5 percent in 1953 and peaked at 1.9 percent in 1959. During the 1960s and 1970s, China’s share in world trade slowed down as a result of its disruptive political and economic relationship with the Soviet Union, and China’s political turbulence caused by the Great Leap Forward and the Cultural Revolution. In 1977, China’s share in world trade was reduced to 0.6 percent.

Under Mao’s closed-door policy, China’s external financing was limited, and it was predominately a cash trader. From 1950 to 1971, China paid all of its foreign purchases by cash and international business transactions were paid by letters of credit. In the 1970s, mutual deposit accounts were established between the Bank of China (BOC) and foreign banks, which allowed the BOC to accept foreign deposits to finance China’s imports. (Grub and Lin, 1991)

Beginning in 1979, Deng Xiaoping opened China’s door to the global economy in order to attract foreign lending, investment, and new technology. From 1979 to 1989, China’s main sources of external borrowing came from foreign governments, international organizations, buyer’s credit, and commercial borrowing. Table 19 shows China’s sources of external borrowing in millions of US dollars and in percentage. Among these external borrowing sources, foreign governments, international
organizations, and commercial borrowing were the main sources of borrowing in the 1980s.

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(In Percent of Total)

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<tr>
<td>Organizations</td>
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<td>15.4%</td>
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</tbody>
</table>


Loans from foreign governments were usually offered in large amounts at low and fixed interest rates with long maturities. Loans of this type were usually used in major infrastructure investments. Loans from international organizations started in the late 1970s and the United Nations Development Program was the first to lend in China, followed by the Population activities Office and the Disaster Relief Office of the United Nations. The International Monetary Fund and the World Bank began lending to China in 1980.
As a member of the World Bank, China also was able to obtain financial and technical resources from the International Development Association and the International Finance Corporation. China was one of the largest borrowers from the World Bank in the late 1980s, with an annual average of 1 billion US dollars.

Besides loans from foreign governments and international organizations, commercial loans from Eurocredit markets and other private sources became prevalent. Since these loans can be used at the borrower’s discretion, China was able to use the funds to pay for imports of machinery and equipment, and to finance major projects.

Another source of funding in China came in the form of foreign direct investment (FDI). FDI, in its classic definition, is defined as a company from one country making a physical investment into building a factory in another country. FDI is direct investment by a foreign company in the production in another country, either by buying a company there or establishing new operations to an existing business. FDI is in contrast with portfolio investment, which is considered an indirect investment, such as buying a country’s supply of shares or bonds. (Bishop, 2004)

To permit FDI, The Law of the People’s Republic of China on Joint-Ventures using Chinese and Foreign Investment was adopted at the second session of the Fifth National People’s Congress in July 1979. This law provided foreign companies a legal status to invest in China. Guangdong and Fujian were the two first provinces to which the State Council granted the rights of autonomy in foreign trade.

To attract FDI, special economic zones (SEZs) were established in the early 1980s. An SEZ is a geographical region that has special economic regulations and other
laws that are more free-market oriented than a country’s typical or national laws.
Moreover, these regulations tend to provide a variety of incentives to foreign companies
that are conducive to FDI. SEZs were also viewed by the Chinese government as a
“window through which to introduce foreign technology, capital, and managerial
techniques.” (Grub and Lin, 1991)

The initial SEZs were established in the coastal cities of Shenzhen, Zhuhai, Shantou, and Xiamen in 1980. Shenzhen, Zhuhai, and Shantou are three cities in the province of Guangdong, with a geographical advantage in their proximity to Hong Kong. These zones would allow easy access to the infrastructural and capital resources of Hong Kong. Guangdong Province would also attract investment from Macao and Southeast Asian countries because many overseas Chinese in these regions came from Guangdong. Xiamen is a major city of Fujian Province. Fujian Province is unique due to its close family ties between the people in Fujian and Taiwan. Since many Taiwan residents migrated from Fujian, most likely they would provide capital investment to Fujian.

Since the establishment of the initial four SEZs, these zones grew rapidly over the next 10 years. Table 20 shows the economic and investment indicators of SEZs in 1989. In 1989, the total industrial output for these four zones reached 5.7 billion US dollars with a total of 1,382 FDI contracts signed in that year, while total exports in these zones reached 3,933 billion US dollars. Among these four SEZs, Shenzhen had the highest levels of industrial output and exports, followed by Shantou, Xianmen, and then Zhuhai.
Besides SEZs, additional effort was made by the Chinese government to accelerate the opening process of China’s economy. In 1984, fourteen coastal cities were opened for foreign investment, with investment regulations and incentives similar to the initial four SEZs. Within each of these opened coastal cities, a special area was designated as an economic and technical development zone (ETDZ). These ETDZs provided more lucrative investment incentives than other parts of the opened cities.

To simplify foreign investment transactions, greater autonomy was given to municipal governments in the decision making of foreign investment projects. Municipal governments were given the right to approve most foreign investment projects, within the amount of 30 million US dollars for large opened cities, and 10 million US dollars for smaller opened cities, without the need for approval from the central government.

In comparison with the SEZs, opened coastal cities had more advantages in attracting FDI than SEZs. First, these coastal cities were more developed than SEZs, in term of industrial infrastructures, at the time of opening up. Second, these coastal cities had well-developed transportation facilities and communication systems. Third, these
coastal cities had workers that were more educated and technicians with more advanced technical skills.

As a result of these advantages, the combined industrial output of the fourteen coastal cities in 1989 was ten times greater than the industrial output of the four SEZs. Total foreign investment to the opened cities was about three times bigger than the foreign investment to the SEZs. (Grub and Lin, 1991)

In addition to SEZs and fourteen opened coastal cities, additional incentives for FDI were introduced in 1986. Through the Provisions of the State Council of the People’s Republic of China for the Encouragement of Foreign Investment formulated by the State Council on October 11, 1986, the Chinese government took a more active approach to attracting FDI. The provisions were aimed at providing preferential tax treatment to foreign joint ventures, eliminating many ‘unfair’ local costs, and allowing access to the supplies of water, electricity, and transportation.

Further policy reforms took place in the 1990s regarding FDI. In April 1990, amendments were made to the Joint Venture Law of 1979. These amendments allowed non-Chinese to act as Chairman of the Board of Directors, extensions to the terms of operation, and removed the limit of registered capital contributed by foreign partners.

In April 1994, the State Council proposed favorable tax policies and selective financial support to joint ventures in the sectors of agriculture, hydropower, communications, energy, and raw material. On June 27th, 1995, the State Council issued the Provisional Guidelines for Foreign Investment Projects. This policy gives priority to
FDI in the sectors of agriculture, energy, transportation, telecommunications, basic raw materials, and high-technology industries.

With the establishment of SEZs, opened coastal cities, and policies to attract FDI, FDI in China has increased significantly since 1979. In the early 1980s, foreign loans were the predominate form of foreign investment, with 85.5 percent of foreign investment in 1980. Over the next 20 years, foreign loans were reduced slowly, and by 2000, to 16.8 percent of foreign investment. The reduced importance of foreign loans was replaced by FDI. FDI rose rapidly from 5.8 percent in 1980 to 68.2 percent in 2000.

Given the rapid increase in FDI since the early 1980s, there were five different forms of FDI in China that contributed to FDI growth. The five forms of FDI include equity joint ventures (EJVs), cooperative operation enterprises or contractual joint ventures (CJVs), wholly foreign-owned enterprises (WFOs), foreign sharing-holding enterprises (SH), and joint exploration (JE). (Fung, Iizaka, and Tong, 2002)

A contractual joint venture is a business entity formed through a partnership between a Chinese enterprise and a foreign enterprise. Profits and losses of CJVs are shared among investors. Normally, foreign partners provide technology while the Chinese partners provide land, labor, facilities, materials, etc. under CJVs.

An equity joint venture consists of at least two investors, one Chinese and one foreign, who hold joint operations and ownership in limited liability corporations. Profits and losses of EJVs are shared among investors according to their respective registered capital contributions.
A wholly foreign-owned enterprise is an investment that is solely owned and operated by a single foreign investor or multiple foreign investors. WFOs are usually structured as limited liability companies, and foreign investors of WFOs receive all profits and bear all risks.

A joint exploration involves the exploration and development of natural resources. Chinese enterprise and foreign enterprise engage in risk sharing and distribution of output according to agreed shares. Through JE, Chinese enterprises were able to acquire equipment and technical support from foreign enterprises for exploration.
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<th>Amount</th>
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<th>Amount</th>
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<th>Amount</th>
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</table>

Sources: China Foreign Economic and Trade Statistical Yearbook, China Statistical Yearbook, various issues.
Table 21 shows actual FDI by types of enterprises between 1979 and 2000. Among these types of enterprises, CJVs and JEs were the most popular in the early 1980s. Since China was at the initial stage of market-oriented development in the early 1980s, CJVs and JEs provided foreign enterprises with lower investment risk. Between 1979 and 1982, CJVs accounted for 45.6 percent of total FDI and JEs accounted for 42.5 percent of total FDI. Over time, the investment shares of CJVs and JEs slowly diminished. In 2000, CJVs accounted for only 15.9 percent of total FDI and JEs accounted for only 1.1 percent of total FDI.

Given China’s economic condition in the early 1980s, FDI through EJVs and WFO were considered risky. Between 1979 and 1982, EJVs accounted for only 8.4 percent of total FDI, and WFO accounted for only 3.4 percent of total FDI. FDI through EJVs started to rise rapidly and peaked in 1987 with 64.2 percent of total FDI, and then slowly diminish over time with 35.8 percent of total FDI in 2000. WFOs started to rise rapidly in the early 1990s, and they accounted for 46.9 percent of total FDI in 2000.


4. Regulations and Policy Incentives on FDI since 1978
   Given the understanding of the changing nature of FDI, China’s rapid FDI growth since 1978 was the result of China’s market-oriented atmosphere toward foreign
investment. Therefore, it is imperative to understand the market-oriented regulations and policy incentives that fostered rapid FDI growth in China. The first step is to understand the general regulations and policy incentives toward FDI; and then the second step is to understand specific regulations and policy incentives toward FDI in SEZs and opened coastal cities.

Regulations and policies on FDI under Deng Xiaoping was very flexible in terms of ownership, project duration, choice of investment, size of investment project, investment locations, management system, and pricing. (Grub and Lin, 1991) Flexible regulations and policies in general would promote FDI.

The freedom for foreign investors to choice FDI ownership was encouraged during the opening up of the 1980s. The Chinese government allowed equity investments up to 100 percent ownership hold by foreign investors. Therefore, foreign investors could choose between a joint venture and a wholly foreign-owned enterprise. The ability for foreign investors to choose ownership type was a fundamental condition for creating flexibility in the operational areas such as production, management, financing, other operational decisions, etc.

With the flexibility to choose ownership share, foreign investors were able to determine how much management autonomy they could exercise. A higher ownership share meant a higher level of management autonomy. With a 100 percent ownership, they would have complete autonomy for internal operations. Even with joint ventures at less than 100 percent of ownership, they faced little government intervention in managing their firms. As long as joint ventures obeyed the laws and regulations on foreign
investment, their highest management and decision-making would come from the boards of directors.

With a flexible internal management system, the Chinese government also provided joint ventures and wholly foreign-owned enterprises with the external conditions necessary to maximize their use of autonomous internal management system. First is the freedom to choose investment sectors. The Chinese government permitted foreign investment in all industrial sectors of the economy. The ability for foreign investors to choose the industrial sectors for their investment helped to create a balanced growth.

With the freedom to choose industrial sectors, comes the freedom to choose investment locations. FDI were initially limited to any locations inside SEZs and opened coastal cities. But over time, the Chinese government relaxed this restriction, and allowed foreign investors to choose any locations for their investment.

Foreign investors were also able to choose the size and duration of investment projects. There was no restriction on the size of foreign investments, which allowed foreign companies of any size to invest in China. Therefore, FDI in China ranged from small sized investment of 100,000 US dollars to large sized investment of several hundred million US dollars. The duration of investment projects could be short-term or long-term, which also was suitable for foreign companies of any size. Smaller sized foreign companies might prefer short-term investment projects, while larger sized foreign companies might prefer long-term investment projects.
Prices for products offered by joint ventures and wholly foreign-owned enterprises in general were separated into market prices and state-determined prices. Market prices were either determined by market forces without government intervention or prices negotiated between the local governments and foreign companies. State-determined prices were divided into floating prices and fixed prices. Floating prices were prices that were adjustable within a margin set by the central government. Floating prices included steel, cement, timber, coal, etc. Fixed prices on the other hand, applied to important commodities such as grain, oil, fuel, and medicine.

Besides general policies to create a flexible foreign investment atmosphere, the Chinese government also introduced investment incentives to attract foreign investment. Investment incentives included tax holidays and exemptions from import and export duties. These incentives helped to reduce the overall operating costs of foreign companies and therefore increased their profitability of doing businesses in China. Table 22 shows detailed tax incentives offered to foreign companies in SEZs, while Table 23 shows detailed tax incentives offered to foreign companies in opened cities and economic and technical development zones.

In SEZs, the corporate income tax rate was 15 percent for all foreign investment, while tax holidays of up to five years were offered to selected investment projects. Tax reductions of 20 to 50 percent were given to investments over 5 million US dollars and high-technology projects. Reinvestment of profits earned by foreign companies was exempt from income tax. Investments involving high-technology transfer over 5 million
US dollars, transportation, and communications were exempt from income tax for up to five years.

<table>
<thead>
<tr>
<th>Table 22 Tax Incentives in SEZs</th>
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<tbody>
<tr>
<td><strong>Special Economic Zones</strong></td>
</tr>
</tbody>
</table>

| **Income Tax** | 1. Income Tax is 15% for manufacturers contracting for business periods of 10 years or more; fully exempt for two years after first making profits, and a 50% reduction for three years thereafter.  
2. Services with foreign capital of US $5 million or more and contracting for business periods of 10 years or more; fully exempt for one year after first making profits, and a 50% reduction for two years thereafter. |
| **Local Income Tax** | Local governments decide on tax reduction measures in SEZs. |
| **Remittance Tax** | Exempt |
| **Income Tax on dividends, interest, leasing and loyalties (in cases where no office is maintained in China)** | 1. Exemption where provided for by existing laws.  
2. 10% for income not falling within category 1 above.  
3. Local governments can adopt further preferential tax reduction measures for firms supplying funds and facilitates under preferential terms or transferring advanced technologies. |
| **Industrial and Commercial Tax on Imports** | 1. Production facilities and raw materials are exempt.  
2. Tax collected for means of transport and other durable consumer goods subject to import restrictions.  
3. 50% reduction for mineral oils, tobacco, liquor, other daily necessities. |
| **Industrial and Commercial Tax on Exports and Domestic Sales** | Exempt (except on export restricted items)  
1. Special Zones taxes for mineral oil, tobacco, liquor are reduced by 50%. Regular or reduced taxes are collected on products designated by local people's governments. Other products are exempted. |
| **Transport Services** | Reasonable quantities tax exempt. |
| **Industrial and Commercial Tax on Business** | 1. Ordinary tax rates applied to earnings from commerce, communications and transport, and services.  
2. 3% for banks, insurance concerns.  
3. Tax reduction measures can be adopted by local governments for firms such as those cited above in the early stage of their operation. |

In opened coastal cities, joint ventures were exempt from income taxes during the first two years of operation, and then they paid only half the taxes during the next three years. Additional benefit was given to high-technology joint ventures, whereby they would continue to pay half of their income taxes for another three years.

Besides joint ventures, 15 percent income tax rate was applied to knowledge-intensive investment and investment exceeding 30 million US dollars. Industrial and commercial taxes were also exempt for production facilities and equipment, parts and raw materials in the production of export goods, packaging materials, transportation-related equipment and office equipment, and daily necessities for foreign personnel. In the Economic and Technical Development Zones (ETDZs) of the opened coastal cities, the uniform income tax rate was 15 percent while the 10 percent of profit remittance tax was exempt.

Table 23 Tax Incentives in Opened Cities and Economic and Technical Development Zones

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<thead>
<tr>
<th>Economic and Technical Development Zones</th>
<th>Opened Cities</th>
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</thead>
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172
| **Income Tax** | Income tax for firms engaged in production is 15%. Firms contracting for 10 years or more are exempt from income tax for 2 years after first making profits, and from 50% of tax for 3 years thereafter. | 1. Income Tax is 15% for technology oriented, knowledge intensive projects of a projection nature with foreign capital of US $30 million or more and a long period of investment recovery, as well as for energy, transport and port construction projects. 2. Income tax is reduced by 20% for the following firms which do not fall in the category 1 above. (i) machinery, electronics industries (ii) metallurgical, chemical construction material industries (iii) light industry, spinning industry (iv) medical equipment, pharmaceutical industries (v) agriculture, forestry, livestock and breeding industries and associated processing industries (vi) construction industry  Tax reduction measures for these industries are subject to the effective periods and limitations specified in the income tax law for joint ventures and foreign enterprises. |
| Local Income Tax | Municipal governments decide on tax reduction measures in development zones. | Local governments can adopt tax reduction measures. |
| Remittance Tax | Exempt | Exempt |
| Income Tax on dividends, interest, leasing and loyalties (in cases where no office is maintained in China) | 1. Exemption where provided for by existing laws. 2. 10% for income not falling within category 1 above. 3. Municipal governments may adopt further preferential tax reduction measures as Economic and Technical Development Zones for firms which supply funds and equipment under preferential terms or transfer advanced technologies. | Same as column 1 |
| **Industrial and Commercial Tax on Imports** | 1. Production facilities, raw materials exempted.  
2. Tax-exempted raw materials used in manufacturing products for domestic sale are subject to the stipulated tax rates. | 1. Equipment, raw materials means of transport exempt.  
2. Tax-exempted raw materials used in manufacturing products for domestic sale are subjected to stipulated tax rates. Reusable amounts of personal effects, means of transport of investors, tax exempt. |
| **Industrial and Commercial Tax on Exports and Domestic Sales** | Exempt (except on export restricted items)  
1. Special Zones taxes for mineral oil, tobacco, liquor are reduced by 50%. Regular or reduced taxes are collected on designated products by local people's governments. Other products are exempted.  
2. Unified industrial and commercial tax collected upon entry into China of cargoes transshipped from special zones and previously exempted, and on products carried in to China after being produced in special zones. Reasonable amounts of personal household affects carried into ordinary areas from special zones. | Same as column 1 |
| **Industrial and Commercial Tax on imported household goods, means of transport and daily necessities** | Reasonable quantities tax exempt. | Same as column 1 |
| **Industrial and Commercial Tax on Business** | 1. Ordinary tax rates applied to earnings from commerce, communications and transport, and services.  
2. 3% for banks, insurance concerns.  
3. Tax reduction measures can be adopted by local governments for firms such as those cited above in the early stage of their operations. | |

The tax incentives offered on Hainan Island was more extensive compared to SEZs and opened coastal cities. All non-financial enterprises were exempt from local income tax on Hainan Island. Tax exemptions of five years were given to long-term investment projects of at least a fifteen-year period, beginning with the first profit-making year, followed by a 50 percent reduction in income tax for the next five years. These long-term investment projects included ports, airports, wharves, roads, power plants, water conservation projects, coal mines, and agricultural projects.

Income tax exemption for 10 years was granted to foreign companies investing in specially designated remote areas, beginning with the first profit-making year, and then followed by 50 percent income tax reduction for the next 10 years. In addition, reinvestment of profits earned by foreign companies would receive tax refunds of 40 percent. Reinvestment of profits in infrastructure and agricultural would receive a 100 percent tax refund. Sales tax on most goods on Hainan Island was exempt from taxes, except mineral oil, cigarettes, liquor, and sugar.

Import duty on Hainan Island was exempt on industrial machinery, equipment, raw materials, communication and transportation equipment, and spare parts. Export goods with 20 percent or more local content were also exempt from export duty.

5. The Impact of Local Government Intervention on Foreign Capital

Through WTO accession in 2001, China’s active interaction with the world economy led to rapid growth of foreign capital, including foreign loans, foreign direct investment (FDI), and other foreign investment. Increase in foreign capital had
contributed significantly to China’s growth of non-state and non-collective enterprises, including private and foreign funded enterprises.

By injecting foreign capital into China’s economy, inflow of foreign capital created jobs, transferred technology and knowledge, improved international trade, and enhanced local competition. This dynamic global interaction transformed China into the second largest recipient of FDI in the world, with 95 billion US dollars in 2009. However, large amounts of foreign capital had been invested unevenly across provinces in China. From Figure 5, we can see that approximately 80 percent of annual FDI was invested into the eastern coastal regions in China.

![Figure 5 FDI Inflows by Region (%)](image)


China can be broken down further into regions based on similarities in geographical locations and economic conditions, including southeastern region, northeastern region, central region, and western region. Southeastern region includes the
provinces of Jiangsu, Guangdong, Shanghai, Zhejiang, Fujian, and Hainan. Northeastern region includes the provinces of Shandong, Beijing, Tianjin, Hebei, and Liaoning. Central region includes the provinces of Hunan, Jiangxi, Henan, Anhui, Hubei, Heilongjiang, Shanxi, Jilin, and Inner Mongolia. Western region includes the provinces of Sichuan, Guangxi, Qinghai, Shaanxi, Yunnan, Gansu, Guizhou, Xinjiang, and Ningxia.

![Figure 6 FDI Inflows by Province in Southeastern China](source)


![Figure 7 FDI Inflows by Province in Northeastern China](source)

Figures 6 to 9 show the differences in the inflow of FDI within the four geographic regions of southeast, northeast, central, and west. The y-axis on these figures represents the percentage of total FDI invested. Between 1979 and 2005, FDI investment slowly converged among provinces in the southeastern region, diverged among provinces in the northeastern region, and stayed about the same among provinces in the central and western regions.
If provinces within each region share similar geographic locations and economic conditions, what causes the differences in foreign investment among provinces within each region? Besides the differences in geographic locations and economic conditions, one of the key factors in the differences in foreign capital inflow among provinces is government institutions.

As observed by economists Acemoglu, Johnson, and Robinson (2004), economic institutions established by a government “determine the incentives of and the constraints on economic actors, and shape economic outcomes.” Therefore, local governments in China play a crucial role in the inflow of foreign capital at the provincial level.

Local government with different economic and political institutions would affect the inflow of foreign capital. It is generally agreed that a government under the rule of law limits the government’s intervention and thus protects private property rights. (North, 1981) On the other hand, Frye and Shleifer (1997) described a “grabbing hand” model of government, in which the extraction of rent by the government, using predatory regulations on private businesses, would deter the growth of these businesses.

Based on the above theories, the following hypothesis is formulated, that economic and political institutions that are more fostering would attract greater foreign investment, whereas less fostering institutions would reduce the attractiveness of foreign investment. Whether a government is more fostering or less fostering depends on the government’s level of intervention in the society, whether economic, social, or cultural.

To determine the level of local government intervention, the size of a government at the regional level can be used as a measuring stick. Government size (GOVSIZE) is
defined as the ratio of the expenditure on government to GDP. (Zhang, 2006) Local
governments with a bigger government size would lead to greater government
intervention, reducing the attractiveness of foreign investment. The data on regional
government expenditure and GDP is between 2000 and 2009, and is collected from
regional Statistical Yearbooks compiled by each of the 31 regions.

To understand the effect of government intervention on foreign investment at the
provincial level in China necessitates breaking down China’s provinces into the four
regions discussed above, including southeastern region, northeastern region, central
region, and western region. Figure 5 shows that about 80 percent of FDI flows into the
eastern coastal regions, while the remaining 20 percent of FDI flows into the central and
western regions.

This uneven foreign investment is the result of geographic and economic
advantages held by the eastern coastal regions. Therefore, China’s provinces are grouped
into each of the four regions with similar geographic locations and economic conditions.
This method would better isolate the effect of government intervention, by filtering out
the effect of geographic locations and economic conditions in the analysis.
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**Table 24 Government Size at Provincial Level (2000-2009)**
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Sources: *Statistical Yearbook of 31 regions, various issues from 2001-2010.*

Note: Missing data are collected from *China Statistical Yearbook from 2001-2010.*
Table 24 shows the government size at provincial level between 2000 and 2009, and is calculated as the ratio of provincial government expenditure to provincial GDP. Provinces are categorized under the 4 regions of southeast, northeast, central, and west. Table 24 also shows the average of government size in each province between 2000 and 2009.

<table>
<thead>
<tr>
<th>Region</th>
<th>Province</th>
<th>Average Government Size</th>
<th>Average Foreign Capital (Unit: USD 10,000)</th>
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</thead>
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<td>Jiangsu</td>
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<td>718803</td>
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<td>Hainan</td>
<td>20.2%</td>
<td>83247</td>
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<td>Hebei</td>
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<td>Shandong</td>
<td>10.5%</td>
<td>841116</td>
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<td>14.7%</td>
<td>520284</td>
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<td>15.8%</td>
<td>681112</td>
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<td>Northeast</td>
<td>Hunan</td>
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<td></td>
<td>Henan</td>
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<td>177531</td>
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<td>Jilin</td>
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<td>176388</td>
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<td></td>
<td>Inner Mongolia</td>
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<td>Central</td>
<td>Qinghai</td>
<td>14.2%</td>
<td>19254</td>
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<td>Shaanxi</td>
<td>17.7%</td>
<td>76848</td>
</tr>
<tr>
<td></td>
<td>Chongqing</td>
<td>18.6%</td>
<td>128286</td>
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Table 25 shows the average government size and average foreign capital at provincial level between 2000 and 2009, and is also categorized by regions. Average government size is taken directly from Table 24. Foreign capital consists of foreign loans, foreign direct investment, and other foreign investment. Average foreign capital is the average between 2000 and 2009.

Table 25 shows that, in general, the average foreign capital is highly correlated with the average government size. Average foreign capitals marked in green are obvious outliers. In the southeastern region, Jiangsu province has the lowest average government size of 2.9 percent and the highest average foreign capital of 1,554,930,000 US dollars. Hainan province on the other hand, has the highest average government size of 20.2 percent and the lowest average foreign capital of 832,470,000 US dollars. Most provinces beside Fujian follow the pattern of negatively correlated average government size and average foreign capital.

In the northeastern region, Hebei province, with the lowest average government size, has a relatively lower level of average foreign capital, while Liaoning province, with the highest average government size, has a relatively higher level of average foreign capital.
capital. Besides Hebei and Liaoning, the other three provinces follow the pattern of negatively correlated average government size and average foreign capital.

In the central region, Hunan province has the lowest average government size of 2.6 percent and the highest average foreign capital of 2,196,920,000 US dollars. On the other hand, Inner Mongolia autonomous region has the highest average government size of 18.8 percent and the lowest average foreign capital of 1,495,790,000 US dollars. Besides Henan province and Anhui province, most other provinces follow the pattern of negatively correlated average government size and average foreign capital.

In the western region, Qinghai province, with the lowest average government size, has a relatively lower level of average foreign capital when compared to other provinces in this region. Ningxia province, with the highest average government size, does have the lowest level of average foreign capital. Besides Qinghai province, Xinjing and Guizhou are also obvious outliers, while other provinces follow the pattern of negatively correlated average government size and average foreign capital.

6. **The Impact of FDI on the Growth of Non-State-Owned Enterprises**

Since the mid-1980s and early 1990s, China’s implementation of market-oriented economic reforms facilitated rapid growth of the collective sector. The growth of collective-owned enterprises was the result of enhanced property rights structure over state-owned enterprises (SOEs). Collective ownership, under collective-owned enterprises, enhanced productive and managerial efficiency in comparison with state ownership under SOEs.
In the mid to late 1990s, two major reforms took place in the state sector due to the inefficient nature of SOEs and their debt-burden on the state. SOE reforms include “grasping large enterprises and letting go of small enterprises” policy to reduce the size of SOEs, and corporatization of SOEs to restructure the existing SOEs. The institutional change to corporatization enhanced the productive and managerial efficiency of SOEs by internally separating the administrative function and enterprise function of SOEs, while externally selling the core assets of SOEs to the public.

As a result of these two major reforms in the state sector, many smaller-sized SOEs were privatized while many existing SOEs were transformed into partially state-owned and partially public-owned enterprises. In addition, collective-owned enterprises that were popular in the late 1980s and early 1990s also started to transform gradually their collective ownership into private ownership throughout the 1990s. The transformation from collective ownership to private ownership would improve the autonomy of productive and managerial decision-making, which would further increase efficiency.

Under Jiang Zemin, these two SOE reforms, ownership transformation of collective-owned enterprises and the support for private enterprise at the national level, became the driving force for the growth of the non-state and non-collective enterprises in the 1990s, including private enterprises, joint ownership enterprises, share-holding enterprises, enterprises with funds from Hong Kong, Macao and Taiwan, and foreign funded enterprises.
Table 26 shows the total investment in fixed assets by types of enterprises from 1993 to 2000. The share of investment in fixed assets by SOEs was reduced from 60.6 percent in 1993 to 50.1 percent in 2000. The share of investment in fixed assets by collective-owned enterprises was reduced from 17.7 percent in 1993 to 14.6 percent in 2000. The combined share of investment in fixed assets by individual enterprises and other types of enterprises increased from 21.6 percent in 1993 to 35.3 percent in 2000.

| Table 26 Total Investment in Fixed Assets 1993-2000 (Unit: 100 million yuan) |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Total                         | 13072  | 17042  | 20019  | 22913  | 24941  | 28406  | 29854  | 32917  |
| State-owned Enterprises       | 7925   | 9615   | 10898  | 12006  | 13091  | 15369  | 15947  | 16504  |
| Share                         | 60.6%  | 56.4%  | 54.4%  | 52.4%  | 52.5%  | 54.1%  | 53.4%  | 50.1%  |
| Collective-owned Enterprises  | 2317   | 2758   | 3289   | 3651   | 3850   | 4192   | 4338   | 4801   |
| Share                         | 17.7%  | 16.2%  | 16.4%  | 15.9%  | 15.4%  | 14.8%  | 14.5%  | 14.6%  |
| Individual Enterprises        | 1476   | 1970   | 2560   | 3211   | 3429   | 3744   | 4195   | 4709   |
| Share                         | 11.3%  | 11.6%  | 12.8%  | 14.0%  | 13.7%  | 13.2%  | 14.1%  | 14.3%  |
| Other Types of Enterprises    | 1352   | 2697   | 3271   | 4044   | 4569   | 5100   | 5372   | 6902   |
| Share                         | 10.3%  | 15.8%  | 16.3%  | 17.7%  | 18.3%  | 18.0%  | 18.0%  | 21.0%  |


After China’s accession to the WTO, intensified global interaction through trade and foreign capital inflow played an important role in China’s economic growth, particularly the growth of non-state and non-collective enterprises. Table 27 shows the gross industrial output value of all state-owned and non-state-owned enterprises in China between 2000 and 2009.
From Table 27, we can see that China’s economic growth between 2000 and 2009 was driven by the private enterprises, limited liability enterprises, share-holding enterprises, enterprises with funds from Hong Kong, Macao and Taiwan, and foreign funded enterprises. The combined gross industrial output value of these enterprises, as a share of the total industrial output value of all enterprises, was 58 percent, and this number rose significantly to 87.7 percent in 2009.
Table 27 Gross Industrial Output Value of All State-owned and Non-state-owned Enterprises in China 2000-2009 (Unit: 100 million yuan)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Enterprises (100%)</strong></td>
<td>85674</td>
<td>95449</td>
<td>110776</td>
<td>142271</td>
<td>222316</td>
<td>316589</td>
<td>405177</td>
<td>507448</td>
<td>548311</td>
<td></td>
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<tr>
<td><strong>State-owned Enterprises</strong></td>
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<td>17229</td>
<td>17271</td>
<td>18479</td>
<td>23519</td>
<td>23519</td>
<td>30728</td>
<td>36387</td>
<td>46857</td>
<td>45648</td>
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<tr>
<td><strong>Share</strong></td>
<td>23.5%</td>
<td>18.1%</td>
<td>15.6%</td>
<td>13.0%</td>
<td>10.6%</td>
<td>10.6%</td>
<td>9.7%</td>
<td>9.0%</td>
<td>9.2%</td>
<td>8.3%</td>
</tr>
<tr>
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<td>10052</td>
<td>9619</td>
<td>9458</td>
<td>9819</td>
<td>9819</td>
<td>10170</td>
<td>8956</td>
<td>9587</td>
<td></td>
</tr>
<tr>
<td><strong>Share</strong></td>
<td>13.9%</td>
<td>10.5%</td>
<td>8.7%</td>
<td>6.6%</td>
<td>4.4%</td>
<td>4.4%</td>
<td>2.9%</td>
<td>2.5%</td>
<td>1.8%</td>
<td>1.7%</td>
</tr>
<tr>
<td><strong>Cooperative Enterprises</strong></td>
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<td>2995</td>
<td>3203</td>
<td>3251</td>
<td>3397</td>
<td>3397</td>
<td>3079</td>
<td>3561</td>
<td>3289</td>
<td>3608</td>
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<tr>
<td><strong>Share</strong></td>
<td>3.4%</td>
<td>3.1%</td>
<td>2.9%</td>
<td>2.3%</td>
<td>1.5%</td>
<td>1.5%</td>
<td>1.0%</td>
<td>0.9%</td>
<td>0.6%</td>
<td>0.7%</td>
</tr>
<tr>
<td><strong>Joint Ownership Enterprises</strong></td>
<td>901</td>
<td>851</td>
<td>942</td>
<td>949</td>
<td>1033</td>
<td>1033</td>
<td>1306</td>
<td>1583</td>
<td>1673</td>
<td>1296</td>
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<tr>
<td><strong>Share</strong></td>
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<td>0.9%</td>
<td>0.9%</td>
<td>0.7%</td>
<td>0.5%</td>
<td>0.5%</td>
<td>0.4%</td>
<td>0.4%</td>
<td>0.3%</td>
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<tr>
<td><strong>Limited Liability Enterprises</strong></td>
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<td>15535</td>
<td>20070</td>
<td>26584</td>
<td>44043</td>
<td>44043</td>
<td>70814</td>
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<tr>
<td><strong>Share</strong></td>
<td>12.8%</td>
<td>16.3%</td>
<td>18.1%</td>
<td>18.7%</td>
<td>19.8%</td>
<td>19.8%</td>
<td>22.4%</td>
<td>22.3%</td>
<td>21.4%</td>
<td>22.1%</td>
</tr>
<tr>
<td><strong>Share Holding Enterprises</strong></td>
<td>10090</td>
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<td>14119</td>
<td>18017</td>
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<td>23121</td>
<td>33597</td>
<td>40159</td>
<td>50204</td>
<td>50209</td>
</tr>
<tr>
<td><strong>Share</strong></td>
<td>11.8%</td>
<td>13.3%</td>
<td>12.7%</td>
<td>12.7%</td>
<td>10.4%</td>
<td>10.4%</td>
<td>10.6%</td>
<td>9.9%</td>
<td>9.9%</td>
<td>9.2%</td>
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<tr>
<td><strong>Private Enterprises</strong></td>
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<td>8761</td>
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<tr>
<td><strong>Share</strong></td>
<td>6.1%</td>
<td>9.2%</td>
<td>11.7%</td>
<td>14.7%</td>
<td>22.4%</td>
<td>22.4%</td>
<td>21.2%</td>
<td>23.2%</td>
<td>26.9%</td>
<td>29.6%</td>
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<tr>
<td><strong>Other Enterprises</strong></td>
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<td>106</td>
<td>143</td>
<td>195</td>
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<td>541</td>
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<tr>
<td><strong>Share</strong></td>
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<td>0.1%</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.3%</td>
<td>0.3%</td>
<td>0.4%</td>
</tr>
<tr>
<td><strong>Enterprises with Funds from Hong Kong, Macao and Taiwan</strong></td>
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<td>11847</td>
<td>13669</td>
<td>17426</td>
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<tr>
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<td>12.4%</td>
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<td>11.0%</td>
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<td>10.7%</td>
<td>10.5%</td>
<td>10.1%</td>
<td>9.5%</td>
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<tr>
<td><strong>Foreign Funded Enterprises</strong></td>
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</table>

The relationship between foreign investment, particularly FDI, and economic growth has been examined in numerous studies. Foreign investment plays an important role in the growth of a country in terms of increasing domestic market competition, acquiring alternative source of capital, introducing advanced managerial and technical skills, and enhancing technology transfer. (Johnson, 1972; Helleiner, 1989)

Quantitative evidence of the positive effect of foreign investment on China’s economic growth has been found in many studies. Chung Chen et al. (1995) find that FDI is positively correlated with China’s economic growth and total investment in fixed assets, while Peter J. Buckley et al. (2001) find that FDI improves the performance of China’s locally owned firms. Statistical evidence of the positive association between FDI and cross-city growth rate differences in China has been found by Shang-Jin Wei (1995).

However, these findings do not account for the regional differences among regions. As explained earlier, about 80 percent of FDI flows into eastern coastal regions. Therefore, eastern coastal regions have a geographic advantage over the central and western regions. Even among eastern coastal regions, southeastern coastal regions have the advantage over northeastern coastal regions due to their close proximity to Hong Kong, Macao and Taiwan. Given the regional differences in geographic location and economic condition, the positive effect of foreign investment on regional or provincial economic growth becomes less clear.

To determine the effect of foreign investment on provincial level economic growth in China necessitates breaking down China’s provinces into four regions,
including southeastern region, northeastern region, central region, and western region. Dividing China into these four regions would remove the effect of geographic location and economic condition advantages held by eastern coastal regions.

The hypothesis posited here is that within each of these four regions, greater foreign investment would generate higher economic growth through the growth of the non-state enterprises at the provincial level after taking out the effect of geographic location and economic condition advantages. More specifically, greater foreign investment improves the performance of non-state enterprises through increased domestic market competition, alternative source of capital, introduction of advanced managerial and technical skills, and enhanced technology transfer.
<table>
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Sources: Statistical Yearbook of 31 regions, various issues from 2001-2010.
Note: Missing data are collected from China Statistical Yearbook from 2001-2010.
### Table 29: Average Foreign Capital Actually Used and Ratio between Non-state-owned and State-owned Enterprises of Average Value-added of Industry in China

<table>
<thead>
<tr>
<th>Region</th>
<th>Average Foreign Capital (Unit: 10,000 USD)</th>
<th>Ratio between Non-SOE and SOE of Average Value-added of Industry</th>
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Table 28 shows foreign capital actually used in China between 2000 and 2009, and the average of foreign capital actually used in those years. Table 29 shows average foreign capital actually used and the ratio between non-state-owned and state-owned enterprises of average value-added in industry between 2000 and 2009. The ratio between non-state-owned and state-owned enterprises of average value-added in industry in Table 14 is calculated by taking the average of value-added in the industrial sector for both non-state-owned enterprises and state-owned between 2000 and 2009, and then by calculating the ratio between the two values.

A ratio of 1 means that both non-state-owned and state-owned enterprises contributed equally to the value-added in the industrial sector; a ratio less than 1 means that non-state-owned enterprises contributed a smaller share of value-added in the industrial sector than state-owned enterprises; and a ratio greater than 1 means that non-state-owned enterprises contributed a greater share of value-added in the industrial sector than state-owned enterprises. To put it another way, a higher value greater than 1 means that non-state-owned enterprises are growing faster than state-owned enterprises in term of valued-added in the industrial sector.

From Table 29, what can be seen is that the growth of non-state-owned enterprises, in term of value-added in the industrial sector, is highly correlated with the average foreign capital in the southeast, northeast, and western regions. Value-added marked in green are obvious outliers. The central region is the only region without a correlation between the average foreign capital and the ratio of average value-added.
In the southeastern region, Hainan province, with the lowest average foreign capital of 832,470,000 US dollars, also has the lowest ratio of average value-added of 1.59. Jiangsu province, with the highest average foreign capital of 15,549,030,000 US dollars, also has the highest ratio of average value-added of 6.38. Fujian province is the only outlier in this region.

In the northeastern region, Hebei province is the only outlier, while all other provinces follow the pattern of positively correlated average foreign capital and ratio of average value-added. Beijing municipality, with relatively low average foreign capital, also has a low ratio of average value-added. Shandong province has the highest average foreign capital of 8,411,160,000 US dollars, and also the highest ratio of average value-added of 3.66.

In the western region, Xinjiang autonomous region with the lowest average foreign capital of 25,780,000 US dollars also has the lowest ratio of average value-added of 0.15. Sichuan province with the highest average foreign capital of 1,710,790,000 US dollars also has the highest ratio of average value-added of 2.48. Ningxia province is an obvious outlier.

7. The Impact of Economic Growth and Open-Door Policy on Labor Mobility

Prior to Deng Xiaoping’s succession as the de facto leader of China in 1978, China’s population since 1949 was strictly controlled by the central government under the hukou system (household registration). Under this household registration system, population was monitored and regulated to restrict population mobility. As a result, only government planned migration was possible.
The hukou system is divided into two types, agricultural hukou and non-agricultural hukou, creating social segmentation between the rural and urban areas. Agricultural hukou is granted to people living in the rural areas, whereas non-agricultural hukou is granted to people living in the urban areas. The two types of hukou determine the social and economic benefits hukou holders receive from the state and their local governments. Non-agricultural hukou holders are entitled to government provided housing, employment, grain rations, education, and medical care. Agricultural hukou holders on the other hand, are entitled to farmland, but they receive very limited government benefits. (Chan and Buckingham, 2008)

In addition to the two types of hukou, hukou is also distinguished by the location of hukou registration. The hukou location is used not only to define where one belongs, but it also determines where one is entitled to receive government provided benefits. Under this system, people are registered based on their place of permanent residence, either in a city, town, or village. The location of one’s hukou is categorized as local and non-local hukou.

Local hukou holders are considered permanent residents, so they are entitled to the government provided benefits discussed above at the place of their permanent residence. Non-local hukou holders are considered temporary residents, so they are not entitled to the government provided benefits at the place of their residence.

In the early 1980s, market-oriented reforms stimulated the mobility of rural laborers. Through increased agricultural productivity under the contract-responsibility system, less rural laborers were needed to work in the farms. As a result, local
governments encouraged rural labor mobility under the slogan “leave the land without leaving the village.” To absorb rural labor surplus, the township and village enterprises (TVEs) were established. In the 1980s, TVEs grew rapidly, and the share of exports for TVEs, as a total of China’s exports in 1990, was five times bigger than in 1985.

To facilitate the growth of TVEs and reduce rural labor surplus, the central government slowly relaxed the restrictions on labor mobility. In 1983, the central government permitted farmers to engage in long distance trade, including transport and marketing of their products beyond local markets. In 1984, farmers were permitted to travel to nearby towns to find work in TVEs. In 1985, temporary residence permits were established for rural migrants.

In 1988, the central government lifted labor mobility restriction in cities, allowing farmers to find work and/or open their own enterprises in cities. According to MOA (2001), as a result of these institutional changes, rural migrant workers increased from 2 million in 1983 to 30 million at the end of 1980s.

However, the food rationing system in the 1980s prohibited long term migration. Under the food rationing system, food and necessities in a local market could be bought only with local coupons. Therefore, migrant workers without local hukou were not eligible to receive local coupons. This system restricted the degree of freedom to migrate.

Starting in the late 1980s, many city governments began to sell hukou for high fees, from a couple of thousand yuan to tens of thousands of yuan. There were several types of fees charged by city governments, including development fee, urban development fee, town development fee, development and accessory fee, and
accommodation fee. The amount charged for hukou depended on the size of a city, and large cities charged higher fees than smaller cities. (Cao, 2001)

In the early 1990s, rapid growth of the eastern coastal regions significantly attracted rural labor force from the inland regions. Beginning in the mid-1990s, coastal cities such as Shenzhen and Shanghai started to offer highly skilled migrant workers with high investment contribution “blue stamp” hukou. (Wong and Huen, 1998) Blue stamp hukou holders were able to transfer their hukou into permanent urban hukou after living in the new place for a certain amount of time.

Around the same time, institutional reforms on state-owned enterprises (SOEs) increased labor flexibility and encouraged the development of the non-state and non-collective sectors. These reforms stimulated rapid growth in urban areas and the demand for rural laborers, resulting in another wave of rural labor migration. According to MOA (2001), migrant workers more than doubled from 30 million at the end of 1980s to 62 million in 1993, and the number reached 75.5 million in 2000.

To facilitate this increased urban growth, the central government relaxed the restriction of the hukou system. Prior to the late 1990s, migrant workers were required to obtain a Migration Registration Card at their local government. Once migrant workers arrived at the destination, they were required to obtain an Employment License. Migrant workers living more than one month at their destination were required to obtain a temporary living certificate.

In 1997, the State Council established testing sites of 450 towns and small cities for hukou reform. Migrant workers who held stable jobs and lived in these towns and
small cities for over two years would be able to obtain urban *hukou.* (Yu, 2002) The two year requirement was further relaxed in 1998. Migrant workers who had been living in the destination place for over one year, and who had legal housing and stable employment, were able to obtain their *hukou* at the destination place. However, the actual implementation of the new policy varied among cities based on their economic and social conditions, and the economic interests of the city residents.

The *hukou* reform of the late 1990s had been uneven among cities. Among the large cities in the eastern regions of China, Shijiazhuang, of Hebei Province, was the most open city in granting *hukou* to migrant workers, with 450,000 new *hukou* granted between August 2001 and June 2003. (Wang, 2003) Most other large cities were much more restrictive in granting urban *hukou* to migrant workers. In those cities, requirements of education, skills, and income were set very high, so only an extremely small number of migrant workers were granted urban *hukou.* (Zhang and Lin, 2000)

Major cities such as Beijing, Shanghai, and Guangzhou, on the other hand, were the most restrictive in granting urban *hukou* to migrant workers. In Beijing for example, many government and private jobs required Beijing *hukou.* (Beijing Chenbao 2006; Fazhi Wanbao 2006) In 2002, for example, Guangzhou stopped granting urban *hukou* because of the huge migrant labor population living in Guangzhou. The stringent requirements on urban *hukou* were and still are a major problem in the large cities, and this problem is unlikely to be solved given the autonomous decision making of the city governments in setting criteria for granting urban *hukou.* (Sun, 2007)
After China’s accession into the WTO in 2001, significant increase in FDI inflow radically increased the demand for rural labor in urban areas. In the mid-2000s, foreign-funded enterprises employed almost 24 million people in China. (Blanchard, 2007) With rapid expansion of the urban areas, the central government further relaxed the *Hukou* system to promote rural labor mobility. Since 2000, the number of migrant workers grew from 75.5 million in 2000 to 136.49 million in 2007. The 136.49 million of migrant workers in 2007 accounted for 46.7 percent of total urban employment. (Cai et al., 2009)

Despite the large flow of migrant workers in recent years, fundamental problems of the *hukou* system are still left unsolved, including labor market segregation, and lack of social welfare benefits for migrant workers. Labor market segregation is the result of *hukou* discrimination between rural and urban *hukou*. Employment in government offices and state-owned enterprises requires urban *hukou*, which means that rural migrant workers are unable to compete in the labor market for these jobs, unless they are able to change their rural *hukou* to urban *hukou*.

Social welfare benefits in urban areas such as public education, unemployment insurance, health benefits, and subsidized low-rent housing create another disadvantage for migrant workers. Migrant workers without local *hukou* are not able to obtain these social welfare benefits. Among these social welfare benefits, public education discrimination against the children of migrant workers is a major social issue today, leaving many migrant workers with no choice but to leave their children with their parents in the rural areas.
Public education is subsidized to citizens in the area of their permanent residence. Migrant workers without local hukou are not being able to enroll their children in local schools for free, unless they pay a fee to enroll their children as “guest” students. However, since there is a quota for “guest” students and the competition for enrollment as “guest” students is high, the fee charged can be a significant portion of migrant workers’ incomes. (Xinhua News, 2002)

Beside public education provided by the government, migrant schools in the cities are opened to the children of migrant workers. These schools are unlicensed schools run by the migrant workers themselves. Since these schools are unlicensed, they are considered illegal underground education. In Beijing for example, the authority suddenly made the decision to shut down 23 migrant schools in September, 2011. (The Economist, 2011)

Other than labor market segregation and lack of social welfare benefits, the working and living conditions of rural migrant workers created another significant social problem. Many of these rural migrant workers work without an employment contract, so they are forced to work long hours. Some rural migrant workers work over 70 hours a week. Out of all the migrant workers in the private sector, only 23 to 30 percent have labor contracts. (Lee, 2007)

Many jobs opened for rural migrant workers are in factories, construction sites, and mines, where the working atmospheres are dangerous. Since most migrant workers do not have health insurance, they have to bear the cost of illness and accidents. At the same time, rural migrant workers have to endure harsh living conditions. Migrant
workers without local *hukou* are not entitled to low-rent housing in the cities, and the private market apartments are too expensive. As a result, many migrant workers live in cramped dormitories. About 75 to 80 percent of migrant workers live in dormitories, with an average of twelve people living into a room of 26 square meters. (Lee, 2007) A room of 26 square meters is equivalent to roughly 280 square feet. This kind of living condition is illegal across America.

To understand the dynamic of migrant workers requires looking at the change of migrant workers over time. Table 30 shows the number of migrant workers in China between 1982 and 2009. The numbers are categorized into *hukou* migrant population and non-*hukou* migrant population. *Hukou* migrants are yearly flow figures of migrant population who have obtained local *hukou* at their destination. Non-*hukou* migrants, on the other hand, are stock figures of migrant population at their destination without local *hukou*. 
Table 30 Major Aggregate Migrant Figures, 1982-2009 (in millions)

<table>
<thead>
<tr>
<th>Geographic boundary (to cross)</th>
<th>Hukou Migrants (Yearly flow figures)</th>
<th>Non-hukou Population (Stock figures) or &quot;Floating Population&quot;</th>
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<td>&quot;Temporary Population&quot;</td>
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<td>2004</td>
<td>19.49</td>
<td>78.0</td>
</tr>
<tr>
<td>2005</td>
<td>19.33</td>
<td>86.7</td>
</tr>
<tr>
<td>2006</td>
<td>20.60</td>
<td>200</td>
</tr>
<tr>
<td>2007</td>
<td>20.84</td>
<td>104.4</td>
</tr>
<tr>
<td>2008</td>
<td>18.92</td>
<td>116.6</td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td>123.7</td>
</tr>
</tbody>
</table>

Source: Chan, K. W., (forthcoming) China, Internal Migration, in Immanuel Ness and Peter Bellwood (eds.) The Encyclopedia of Global Migration, Blackwell Publishing, Table 1, p.9.
Looking at Table 30, the number of *hukou* granted to migrants is stable over time. *Hukou* migrants in 1982 were 17.3 million, while *hukou* migrants in 2009 were 18.92 million. Between 1982 and 2009, the number of *hukou* granted ranges from 16.87 million to 20.84 million. In conclusion from this data, rapid economic growth in China had little effect on the number of *hukou* migrants over the past two decades.

However, rapid economic growth in China does have a major impact on the non-*hukou* migrants. From Table 30, the data for non-*hukou* migrants is separated into categories, depending on the duration of their stay at their destination, including overnight, 3 days, 6 months, 6 months or one year, and regularly engaged in work outside. Looking at non-*hukou* migrants who have regularly engaged in work outside, the change was significant, from 26 million in 1988 to 79.8 million in 1998. The rapid increase in non-*hukou* migrants between the late 1980s and 1990s was driven by the growth of the collective and the private sectors.

This rapid increase in non-*hukou* migrants slowed down in the late 1990s. Looking at the category of 6 months, the number of non-*hukou* migrants grew only from 60 million in 1996 to 63.7 million in 1999. Slow growth in non-*hukou* migrants during this period was the result of reforming SOEs. Under the SOE reforms of corporatization and letting go smaller-sized SOEs, the temporary increase in urban unemployment led to reduced demand growth for migrant workers.

After China’s accession into the WTO in November 2001, the demand for non-*hukou* migrants was revived again through increased global trade interaction. The WTO accession allowed China to significantly increase their imports and exports, and it also
provided a much greater opportunity for foreign companies to invest in China. These two effects, in addition to China’s continued rapid economic growth, created a much bigger demand for non-hukou migrant workers in the urban areas.

Between 2002 and 2009, non-hukou migrants in the category of regularly engaged in work outside rose from 104.7 million to 145.3 million. Non-hukou migrants in the category of 6 months reflected the same outcome. From this data, we can see that rapid increase in foreign investment after China’s accession into the WTO had a major impact on the increased demand for non-hukou migrant workers.

Stable hukou migrant population and rapid increase in non-hukou migrant population also implies the rigidity of the hukou institutions. Between the late 1980s and 1990s, China’s rapid economic growth driven by domestic market-oriented reforms had little or no impact on the hukou institutions, which is represented by the stable number of hukou granted to migrant population. This means that the regional governments were reluctant to make urban areas in their regions more open and accessible to rural migrant workers. With increased foreign investment after China’s WTO accession, foreign investment had a major effect on non-hukou migrant population, but it had little or no impact on the hukou institutions.

8. Conclusion

China’s rapid economic development and urbanization over the past three decades indicated the success of China’s market-oriented economic reforms at different stages of time. According to the annual GDP growth rate data calculated by the World Bank
China’s economic reforms came in stages: agricultural productivity growth, establishment of collective-owned enterprises, establishment of SEZs, further opening up of eastern coastal cities, creating regulations and incentives to attract FDI, reform of SOEs, and support for private enterprises. These reforms led to China’s rapid economic growth in the 1980s and 1990s.

The momentum for continued growth accelerated in the 2000s after China’s accession to the WTO in November 2001. Through increased international trade, foreign investment in China rose significantly. Foreign investment inflow dates back to the early 1980s, when China, in order to attract more foreign investment, established SEZs, and opened eastern coastal cities using more autonomous and flexible economic policies. Therefore, China’s economic growth prior to its accession to the WTO was also impacted by foreign investment inflow. However, foreign investment inflow grew exponentially after China’s accession to the WTO; therefore, it played a much bigger role in China’s continued rapid economic growth in the 2000s.

Foreign investment in China has been uneven, with the majority of foreign investment flowing into the eastern coastal regions because of the eastern coastal regions’ geographic and economic advantages over the central and western regions. After filtering out the effect of geographic and economic advantages, provincial governments, with a smaller government size as measured by provincial government expenditure, attracted greater foreign investment.
Once the relationship between the size of the provincial government and foreign investment has been established, it is imperative to determine the impact of foreign investment in promoting the growth of non-SOEs, particularly private enterprises. Foreign investment is a major contributing factor to a country’s growth through increased domestic market competition, additional source of financial capital, advanced managerial and technical skills, and improved technology. (Johnson, 1972; Helleiner, 1989)

Given these benefits, provinces with bigger foreign investment inflow would lead to greater provincial economic growth. After filtering out the effect of geographic and economic advantages, provincial governments with bigger foreign investment inflow are highly correlated with greater provincial economic growth. Therefore, in conclusion, foreign investment inflow has a significant effect on provincial economic growth.

The result of China’s economic reforms and growth was the rapid growth of labor mobility, from rural areas to urban cities. Labor mobility under Mao Zedong was strictly restricted under the hukou system, which monitored and regulated the population to prevent population mobility. Since 1978, labor mobility restriction was gradually reduced to keep up with China’s rapid urbanization and demand for rural labor.

However, increased labor mobility without fundamental reform of the hukou system created major economic and social problems for rural migrant workers. Major issues faced by migrant workers include labor market segregation, lack of social welfare benefits, and harsh working and living conditions. Labor market segregation is the result of hukou discrimination between rural and urban hukou holders. Rural migrant workers
without urban *hukou* are not able to find work in government offices and state-owned enterprises.

Rural migrant workers without urban *hukou* are not able to obtain social welfare benefits provided to urban *hukou* holders, including public education, unemployment insurance, health benefit, and subsidized low-rent housing. More importantly, children of rural migrant workers are often denied public education in urban cities. As a result, migrant workers have to pay a high fee to enroll their children in local public schools. Otherwise, they are left with no other choice but to attend underground schools organized by rural migrant workers themselves. These schools are considered illegal, and face the risk of being shut down by local governments.

Besides labor market segregation and lack of social welfare benefits, rural migrant workers face harsh working and living conditions. Many of these migrant workers work without employment contract. They are forced to work long hours and some work over 70 hours a week.

Many migrant workers work in factories, construction sites, and mines that are considered to be a dangerous working atmosphere, and they have to bear the cost of illness and accidents if they cannot afford health insurance. Also, many rural migrants live in cramped dormitories, in which twelve people live in a room of 26 square meters. (Lee, 2007)

By looking at the data on the trend of migrant population between 1982 and 2009, the size of migrant population that obtained local *hukou* at their destination was stable over time, while the size of migrant population without *hukou* at their destination
increased rapidly over time. This trend revealed that China’s rapid economic growth driven by both domestic market-oriented reforms and foreign investment had a major impact on the demand for rural migrant workers, but it had little or no impact on the hukou institutions, represented by the stable number of hukou migrant population.

Given China’s rapid economic growth over the past three decades, it is clear that China’s market-oriented reforms and its open-door policy were successful. Particularly after China’s accession to the WTO in November, increased international trade and foreign investment inflow accelerated the growth of non-SOEs and labor mobility. However, a nation’s prosperity contains more than just economic growth. To truly understand whether or not China is becoming more prosperous, it is also necessary to measure China’s economic development in terms of economic and political freedom. The key is to determine whether or not China’s rapid economic development improved people’s economic and political freedom in China.

Economic freedom and political freedom are inter-related, like two sides of a coin. Under China’s unique socialist market economy, central political control and market economy co-exist. Therefore, economic freedom and political freedom in China has to be measured independently. This measurement would then provide a clear understanding of China’s changing prosperity over the past three decades of reforms.

According to the survey Economic Freedom of the World (Economic Freedom of the World, 2011), four key ingredients of economic freedom include personal choice over collective choice, voluntary exchange coordinated by markets, freedom to enter and compete in markets, protection of persons and their property from aggression by others.
After examining China’s economic reforms using the four ingredients, China has gradually improved and moved toward greater economic freedom.

But a thorough examination is required for each of the four ingredients in order to gain a deeper understanding of China’s progression toward a more free economy. On the issue of personal choice over collective choice, China has gradually shifted from collective choice to personal choice. This is evident in China’s reduction of SOEs and collective-owned enterprises in the 1990s, and rapid growth of private enterprises in the 2000s. Rapid growth of private enterprises also implies greater voluntary exchange coordinated by markets.

Increased private enterprises and greater dependence on market forces also implies greater freedom of private enterprises to enter and compete in markets. However, the rigid hukou institutions in China have the opposite effect on rural migrant workers. As examined earlier, rural migrant workers without local hukou faced job market segregation and were deprived of the right to receive social welfare benefits. As a result, their freedom to make permanent migration is restricted.

The rigid hukou system also undermines the protection of persons and their property from aggression by others. Unlike urban permanent residents with local hukou, migrant workers without local hukou are not protected under social welfare benefits, such as unemployment insurance, health insurance, public education, and subsidized low-rent apartments. As a result, migrant workers without local hukou have to endure harsh working and living conditions. When migrant workers organize schools to provide education for their own children, they face the risk of being shut down by local
governments. After all, the lack of protection for migrant workers and their property from aggression by local governments is part of a bigger issue, i.e., the overall lack of a well-established property rights structure in China.

Political freedom in China under the authoritarian regime falls far behind economic freedom. A good measuring stick for China’s political freedom is the Constitutions of the United States and the Bill of Rights. The Bill of Rights is the collective name for the first ten amendments to the U.S. constitutions, established to protect the natural rights of people’s liberty and their property. In essence, the Bill of Rights guarantees the citizens of the U.S. a number of personal freedoms and defines specific limits on the power of the U.S. federal government.

The key issues in the Bill of Rights include the right to vote, the freedom of assembly, the freedom of speech, and the protection from unreasonable search and seizure. The right to vote in China is very limited, with elections held at the village level only. Under the Organic Law of Village Committees, all of China’s villages are expected to hold elections, which are used to determine the village chiefs. According to BBC News, widespread bribing and corruption are regularly reported in the official media. (Hogg, 2010)

The freedom of assembly is the right to join together with others to reach common goals and express common opinions, both in public and in private. Under the authoritarian regime, the Chinese government does not tolerate the freedom of assembly. The June 4th 1989 crackdown proved the lack of individuals’ right to join together to
express their opinions. Smaller scaled assembly in China is often ended by the local police force.

The freedom of speech is a political right to communicate one’s opinions and ideas via speech. The Chinese media are heavily regulated and strictly monitored to prohibit the freedom of speech in China. With the rapid growth of internet users in China, internet censorship in China is one of the most stringent in the world. According to The New York Times, Chinese government intercepts internet data and compares it against an ever-changing list of banned keywords or websites. (The New York Times, 2010) Websites such as Facebook, YouTube, and Twitter are permanently banned in China.

The protection from unreasonable search and seizure is another major issue faced by the citizens of China. Without a well-established property rights structure and the rule of law, the Chinese citizens are not protected against unreasonable search and seizure. In the news report recently, Chinese civil rights activist Chen Guangcheng, who advocates women’s rights and the welfare of the poor, was placed under house arrest from September 2005 to March 2006 at his home in Dongshigu Village by the Chinese government, for exposing alleged government abuses in official family-planning policy.

After escaping from his house arrest, he fled to the U.S. Embassy in Beijing on April 22nd, 2012, Chen Guangcheng’s case drew the attention of the media in the world. As a result, Chen and his family were granted U.S. visas to come to America. According to The New York Times, before Chen left China, he expressed his concern that his relatives and other activists who helped him during his escape would be punished by the Chinese government. (Jacobs, 2012)
Even though China’s rapid economic growth has turned China into a more prosperous nation, this growth pattern is unlikely to be sustainable in the long run, unless the Chinese government makes greater effort to promote economic and political freedom. Since China’s rapid growth in the past was the result of increased economic freedom, then greater economic and political freedom is a necessary condition to transform China from a developing country to a more developed country.
1. Introduction

Since the implementation of market-oriented reforms and the open-door policy under Deng Xiaoping in 1978, this top-down approach to economic reforms has gradually moved China toward greater economic freedom. Greater economic freedom means greater reliance on market forces, and has led to China’s rapid economic growth in the past three decades. On the other hand, however, political freedom made little progress in China. The recent purge of civil rights activist Chen Guangcheng, and the one-child policy, among other issues, proved that little effort was made by the Chinese government to improve human rights in China. Would greater economic freedom create a catalyst to a greater political freedom in China over time?

Greater political freedom is the result of relaxed political control at the top of the political hierarchy. Therefore, if economic freedom does affect political freedom, then the effect must come from political leaders. This means that economic freedom would create some kind of mechanics that would lessen the dictatorial behavior of political leaders via the bottom-up process. Reduced dictatorial behavior of political leaders would translate into less restrictive political policies via the top-down process, and that would result in
greater political freedom over time. Thus, it is imperative to examine how economic freedom would affect the behavior of political leaders.

2. A Model of Dictatorship

Dictatorial leaders have a greater ability and tendency to use repression to achieve their political objectives in comparison to democratic leaders. A measurement of the difference in the level of repression between dictatorial and democratic regimes is determined by whether citizens have the right to vote. Under a democratic regime, citizens have the right to vote, allowing them to pursue their individual economic and political interests. Under a dictatorial regime, citizens do not have the right to vote, and are prohibited from pursuing their individual economic and political interests.

In the case of China, China’s dictatorial leaders limited their citizens’ right to vote in the political arena. Elections were only allowed at the village level to elect village chiefs. Restricting the economic and political freedom of the citizens of China allowed the leaders of China to exercise control via top-down economic and political planning. This institutional structure resulted in uneven distribution of economic and political power, where power was concentrated at the top of the political hierarchy. This uneven distribution of power led to the abusive behavior of the Chinese dictatorial leaders, resulting in their use of harsh repression against the citizens of China.

Repression used by Chinese dictatorial leaders played (and still plays) a key function in China, particularly so during the period of Mao Zedong’s political domination. One of the harshest repressions in the human history was the violent mass movement of the Cultural Revolution led by Mao in 1966. The Cultural Revolution was a
class struggle against the liberal bourgeois. Millions of people in China were persecuted. According to writer Jung Chang and historian Jon Holliday (2005), in their book “Mao: The Unknown Story”, more than 3 million people were dead as a result of the Cultural Revolution; Walder and Su (2003) estimated that 36 million people suffered some form of political persecution. In addition, young people from the cities were forced to migrate to the countryside, and their standard education was replaced by the propaganda teachings of the Communist Party.

After the Cultural Revolution, the June 4th 1989 crack-down was another major repression led by the de facto leader Deng Xiaoping in 1989. The June 4th incident started out as a sequence of student protests in Tiananmen Square. The protestors demanded that the Chinese government accelerate market-oriented reforms, and they asked for greater political freedom.

At the height of these protests, about 100,000 people gathered in Tiananmen Square. To ensure the stability of the Communist Party, Primier Li Peng ordered a crackdown, resulting in the killing of civilians and the arrests of several high-ranking reformist politicians. The actual number of casualties was unknown, but Nicholas D. Kristof of The New York Times wrote that "it seems plausible that about fifty soldiers and policemen were killed, along with 400 to 800 civilians." (Kristof, 1989) The severity of this crackdown was comparable to the Cultural Revolution, but the scale of this crackdown, in terms of the death rate, was significantly smaller compared to the Cultural Revolution.
When Jiang Zemin came into power, he restricted the power of the military by curtailing commercial businesses run by the military, and by cutting 500,000 soldiers from the People’s Liberation Army (PLA). At the same time, Jiang reduced the use of repression in China. During his presidency, Jiang’s only major use of repression was the persecution against the members of the Fulun Gong group in 1999. However, the severity of repression used against the Fulun Gong group was much less compared to the Tiananmen Square crackdown.

Hu Jintao on the other hand, took a harsher stand toward political policies in order to promote China’s social stability. While in power, Hu increased the military budget by a double-digit annual growth rate and enacted a strong media censorship to ensure a “harmonious” society, in which people live together as a repressed society. Hu took a tough stand on repressing human rights dissidents and on the people of Tibet.

However, the levels of repression used by China’s political leaders over the past several decades has varied among Mao Zedong, de facto leader Deng Xiaoping, former President Jiang Zemin, and current President Hu Jintao. Mao’s harsh political, economic, and military actions were dramatically reduced by Deng Xiaoping. Besides the June 4th crack-down at Tiananmen Square, Deng’s pro-market ideology lay down the foundation for China’s transition to authoritarian capitalism. Under this institutional structure, Jiang improved China’s economic freedom and reduced the level of repression used by previous leaders. However, Hu reversed this trend by increasing the level of repression through increased defense spending, heavy media and internet censorship, and the attack on human rights dissidents.
To understand the logic of politics and varying levels of repression used by political leaders, Bruce Bueno De Mesquita and Alastair Smith (2011) establish the rules of politics in their book “The Dictator’s Handbook: Why Bad Behavior is Almost Always Good Politics.” In their book, Mesquita and Smith explain the rules that political leaders have to follow in order to win enough support to assume power and stay in power, and how these rules govern the behavior of political leaders, making them to be either more repressive or less repressive toward their people.

According to Mesquita and Smith, the political landscape for leaders is composed of three groups of people: the nominal selectorate, the real selectorate, and the winning coalition. The nominal selectorate is “every person who has at least some legal say in choosing their leader,” the real selectorate is “the group that actually chooses the leader,” and the winning coalition is “the subset of the real selectorate that makes up a winning coalition.” (Mesquita and Smith, 2011)

At the fundamental level, these three groups are considered interchangeables, influential, and essentials because “the nominal selectorate is the pool of potential support for a leader; the real selectorate includes those whose support is truly influential; and the winning coalition extends only to those essential supporters without whom the leader would be finished.” (Mesquita and Smith, 2011)

In a democratic country like the United States, the nominal selectorate consists of all eligible voters (all citizens aged eighteen and over), the real selectorate consists of the electors of the Electoral College, and the winning coalition is the small fraction of voters whose vote determines the winner among presidential candidates. Under a dictatorial
country like North Korea, the nominal selectorate consists of everyone in the population. However, only a small number of real selectorate actually pick their leader behind the scene, and a winning coalition (probably a few hundred) keep the leader of North Korea in power.

Whether a country is democratic or dictatorial does not really matter from a ruling perspective, because the basic political outcomes are determined by the relative size of interchangeables, influentials, and essentials. (Mesquita and Smith, 2011) Therefore, the difference between a democratic country and a dictatorial country depends on the relative changing size between the three supporting political groups above.

To gain political support and optimize loyalty among these three groups, money is the key to the success of leaders because they need to pay supporters. There are two aspects of money for leaders in the political arena. First, leaders have to extract money from their citizens. And second, leaders have to know how to distribute money among the three groups. The extraction and redistribution of money depend on the relative size of the winning coalition and the selectorate.

There are many ways for a leader to extract money, which include personal income taxes, property taxes, duties on imports, licenses, and government fees of all kinds. To simplify the matter, the methods for extracting money are generalized as taxation. How much money to extract depends on the relative size of the winning coalition to the selectorate, and that also determines how much money to distribute among the groups.
If the relative size of the winning coalition is small, a sensible focus is for leaders to provide private benefits to the members of the winning coalition. To provide greater private benefits, leaders have to extract more from their citizens, resulting in higher tax rates. If the relative size of the winning coalition is large, then for leaders to focus on providing private benefits to the members of the winning coalition becomes less affordable or sustainable. Therefore, leaders would have to focus more on providing public goods, resulting in relatively lower tax rates.

Since political survival for leaders depends on the extraction and redistribution of money, Mesquita and Smith (2001) identified fives basic rules which determine the success of political leaders. Below are the five basic rules of political survival:

**Rule 1: Keep your winning coalition as small as possible.** This rule suggests that when leaders rely on a small winning coalition, they have more control and discretion over expenditures.

**Rule 2: Keep your nominal selectorate as large as possible.** This rule suggests that when leaders maintain a large number of interchangeables, disciplining the behavior of influential and essentials is helpful, because there are a large number of substitutes for their positions.

**Rule 3: Control the flow of revenue.** This rule suggests that leaders controlling the cash flow is better than allowing people to feed themselves. The most effective strategy for leaders is to make most people poor and keep a small number of supporters rich.
Rule 4: Pay your key supporters just enough to keep them loyal. This rule suggests that leaders should provide their coalition with just enough money and nothing more. Otherwise, they would find someone to replace their leaders.

Rule 5: Don’t take money out of your supporter’s pockets to make the people’s lives better. This rule suggests that leaders should not follow the opposite of rule number 4. If making people’s lives better reduces supporters’ private benefits, they would seek a new leader to replace the existing one. (Mesquita and Smith, 2001)

3. The Political System and Structure of China
Prior to analyzing the changing nature of China’s dictatorship, understanding the political structure of China is necessary. The political system of the People’s Republic of China (PRC) is divided between the Communist Party of China and the state. The core organ of power in the CPC is the National Congress of the CPC, and the primary organs of power in the state are the National People’s Congress, the President, and the State Council.

The CPC is the founding and the only ruling political party of the PRC. The CPC is the largest political party in the world, with over 80 million members at the end of 2010. (Xiong, 2011) The size of the CPC relative to the total population of China is about 6 percent. The legal power of the Communist Party is written under the Constitution of the PRC, which grants the CPC power over the state, military, and media. (Folsom, Minan, and Otto, 1992) All Chinese citizens over the age of 18 can apply for Party membership, given that they are atheists and accept the Party’s constitutions. In 2010,
among the 21 million applicants to the Party’s membership, only less than 15 percent were accepted. (Lawrence and Martin, 2012)

All Party members must be organized into units in order to participate in the activities of the Party. Party units exist in state-owned enterprises, rural areas, government departments, schools, scientific research institutes, communities, mass organizations, and since 2010, they also existed in over 400,000 private businesses and foreign-owned enterprises. (Xinhua, 2010)

China’s top leadership is considered collective, with the Politburo of the Communist Party of China as the highest decision-making body, consisting of 25 members who oversee the CPC. Members of the Politburo hold power positions in the state and at the regional level. In theory, members of the Politburo are appointed by the Central Committee of the CPC, but in practice, they are determined by its existing members. The Politburo meets once a month and the agenda is set by the General Secretary. The decisions in these monthly meetings are made by consensus rather than by majority vote. (Miller, 2004)

Within the Politburo, the power is centralized by the Standing Committee of the Communist Party of China (PSC) as the highest decision-making body, consisting of 5 to 9 top leaders in China. As members of the PSC, they also hold important posts in both the CPC and the State. The current makeup of the 9 members of the PSC and their posts in the Party and the State are listed in Table 31. The PSC is responsible for the majority of decisions made by the Party and the State. Like the Politburo, the inner dynamics of the
PSC is unknown, but it is believed that the consensus involves bargaining and maneuvering among the 9 members. (Miller, 2011)

### Table 31 The 17th Politburo Standing Committee of the Communist Party of China

<table>
<thead>
<tr>
<th>Rank</th>
<th>Current Members</th>
<th>Party Positions</th>
<th>State Positions</th>
</tr>
</thead>
</table>
| 1    | Hu Jintao       | 1. General Secretary of the CPC Central Committee  
2. Chairman of the CPC Central Military Commission | 1. President of the People's Republic of China  
2. Chairman of the PRC Central Military Commission |
| 2    | Wu Bangguo      | Party secretary of the Standing Committee of the National People's Congress | Chairman of the Standing Committee of the National People's Congress |
| 3    | Wen Jiabao      | Party secretary of the State Council of the People's Republic of China | Premier of the State Council of the People's Republic of China |
| 4    | Jia Qinglin     | Party secretary of the National Committee of the Chinese People's Political Consultative Conference | Chairman of the National Committee of the Chinese People's Political Consultative Conference |
| 5    | Li Changchun    | Chairman of the CPC Central Guidance Commission for Building Spiritual Civilization |                       |
| 6    | Xi Jinping      | 1. Top-ranked Secretary of the Central Secretariat of the CPC  
2. Vice Chairman of the CPC Central Military Commission  
3. President of the Central Party School of the CPC | 1. Vice President of the People's Republic of China  
2. Vice Chairman of the PRC Central Military Commission |
| 7    | Li Keqiang      | Deputy Party secretary of the State Council of the People's Republic of China | First-ranked Vice Premier of the State Council of the People's Republic of China |
| 8    | He Guoqiang     | Secretary of the CPC Central Commission for Discipline Inspection |                       |
| 9    | Zhou Yongkang   | Secretary of the CPC Central Political and Legislative Committee |                       |

The next level down in the CPC is the Central Committee, with 204 members and 167 alternative members. The Central Committee consists of the General Secretary, members of Politburo, members of CMC, and other leading figures in the party and state. The Central Committee meets annually, known as plenary session. The members of the Central Committee are elected by the National Congress of the CPC. Approximately 62 percent of these members were replaced each year on average over the past 30 years. Since the Central Committee has a high turnover rate, much larger than the Politburo, and they only meet on an annual basis, critical political and economic decisions are made by the Politburo rather than by the Central Committee.

The base of China’s top collective leadership is the National Congress which holds a meeting once every five years at the Great Hall of the People in Beijing. The National Congress currently has 2213 delegates, selected from grassroot party organizations. In theory, major leadership and constitutional changes are made in these meetings, but in practice, these decisions are made by the politburo before the meetings. Therefore, the National Congress is only symbolic only rather than being an assembly with independent power.
The highest organ of state power of the PRC is the National People’s Congress (NPC), which is the only legislative house in the PRC. Under the Constitution, NPC is responsible for overseeing the Presidency, the State Council, the Central Military Commission, the Supreme People’s Court, and the Supreme People’s Procuratorate. (Lawrence and Martin, 2012) The NPC meets every five years in the Great Hall of the People, which approves changes to the Party Constitution and elects the President, Vice President, and all members of the Central Committee of the CPC.

The NPC consists of about 3,000 delegates. The current chairman is Wu Bangguo. The delegates of NPC are elected by the provincial people’s assemblies for five-year terms. About 70 percent of current delegates are members of the CPC, which
means their loyalty is to the party first. Also, NPC deputies are not elected directly by the provincial people’s assemblies; they are nominated by the CPC. In practice, the composition of the NPC and the Party’s nomination of NPC deputies allows the CPC to maintain effective control over the NPC. As the highest state power, the NPC approves or rejects new legislations drafted by the CPC. Since the NPC rarely reject proposals, the NPC is really a symbolic entity that is powerless. The BBC describes the NPC as a rubber-stamp legislature which supports the decisions made by the CPC. (Bristow, 2009)

The highest executive and administrative body of the PRC is the State Council, with 35 members. It is chaired by the Premier. The members of the State Council include the premier, one executive vice premier, three vice premiers, five state councilors, and 25 ministers of major agencies, who are appointed by the National People’s Congress. The current Premier of the State Council is Wen Jiabao. The State Council is the chief administrative authority, and directly oversees subordinate governments in the provinces.

As the highest executive and administrative body of the PRC, the main tasks of the State Council include carrying out the policies of the CPC as well as the regulations and laws adopted by the NPC, and dealing with China’s internal and external affairs, such as economy, finance, culture, education, national defense, and diplomacy. (People’s Daily, n.d.) In regard to national defense, the State Council does not control the People’s Liberation Army, but it controls the Ministry for National Defense.

The highest military body of the PRC is the Central Military Commission (CMC), which commands the People’s Liberation Army and the People’s Armed Police (PAP). The CMC is a parallel national defense organization under the names of CMC of the
People’s Republic of China and CMC of the Communist Party of China. The two commissions use an identical institution with an identical membership.

The current chairman for both commissions is Hu Jintao, who also serves as the commander-in-chief of the armed forces. The Vice Chairmen of the CMC are Xi Jinping, Guo Boxiong, and Xu Caihou. In theory, the members of the Party CMC are elected by the Central Committee of the CPC and the members of the State CMC are elected by the NPC of the PRC. However, in practice, memberships are controlled and determined by the 9 members of the PSC.

The military chain of command starts from the CMC to the four General Headquarters, including the General Staff Department, the General Political Department, the General Logistic Department, and the General Armament Department. The four General Headquarters command the ground force, the navy, the air force, the military regions, the Second Artillery Corps, the National Defense University, and the Academy of Military Science. In theory, the CMC is the highest military command authority, but in practice, the military decisions regarding national defense are made by the Politburo of the CPC.

Under the command of the CMC, the PLA is a unified military organization, consisting of the PLA Ground Force, the PLA Navy, the PLA Air Force, the Second Artillery Corps, and the PLA Reserve Force. The PLA is the world’s largest military force, with approximately 2.25 million members. The PAP on the other hand, was formed in 1982 by removing the domestic security function of the PLA, and transferring some of
the military forces from the PLA to the PAP. The PAP has approximately 1.5 million members, with over half of its members (800,000) employed in its internal security units.


The Tiananmen Square protests of 1989 provided a perfect scenario to analyze the changing nature of China’s dictatorship. Soon after the June 4th 1989 crackdown, the General Secretary of the CPC Zhao Ziyang was replaced by Jiang Zemin, and de facto leader Deng Xiaoping stepped down as the Chairman of the Central Military Commission (CMC). After this transition, the new leadership increased the speed of market-oriented reforms, particularly the institutional reform of state-owned enterprises (SOEs) and China’s accession to the WTO.

To understand the changing nature of China’s leadership leading up to the Tiananmen Square protests requires tracing back to the period of political transition after Mao’s death in September 1976, and then decomposing China’s top leadership. Before Mao’s death, Mao named Hua Guofeng as his successor. After Mao’s death Hua Guofeng assumed Chairmanship of the CPC and the Chairman of the Central Military Commission. Once in power, Hua restructured the members of PSC for the 11th Central Committee of the Communist Party of China, which was in session from 1977 to 1982. Among the 8 members of the PSC, Hua Guofeng, Ye Jianying, and Deng Xiaoping were at the top, while Li Xiannian, Wang Dongxing, Chen Yun, Hu Yaobang, and Zhaozhiyang were added as new members. Even though Deng was purged by Mao, his official positions were restored at the Third Plenum of the Tenth Congress held in Beijing in July 1977.
As Deng gradually gained more power in the CPC, Deng denounced Hua for promoting Two Whatevers, a policy stating “We will resolutely uphold whatever policy decisions Chairman Mao made, and unswervingly follow whatever instructions Chairman Mao gave.” Given the unpopular Two Whatevers policy, Deng demoted Hua to junior Vice Chairman of the Central Committee of the CPC and then abolished this post in 1982. As a result of Hua’s demotion, Hua was removed from the number 1 rank in the PSC and became an ordinary member of the Central Committee of the Party Congress.

Among the 8 politburo standing members, Wang Dongxing also was removed from the PSC for his close connection with Hua. At the same time, Hua’s important posts were replaced by Zhao Ziyang as Premier in 1980, and Hu Yaobang as Party Chairman in 1981. The promotion of Hu Yaobang pushed him to the number 1 rank in the PSC, while the promotion of Zhao Ziyang pushed him to the number 4 rank in the PSC.

The removal of Hua and Wang reduced the size of the PSC from 8 members to 6 members for the 12th Central Committee of the Communist Party of China, which was in session from 1982 to 1987. According to the dictator’s model established here, the PSC is considered Deng’s winning coalition or essentials. Therefore, the reduction in the size of the PSC reduced Deng’s winning coalition, implying that Deng had more control and discretion over expenditures. A smaller winning coalition also means that a dictator has to focus more on private goods rather than public goods to all his citizens.

Deng’s implementation of fiscal decentralization was essentially a policy to increase private goods at the provincial level. By allowing provincial governments to collect their own taxes and redistribute a portion of the taxation collected to the central
government, provincial governments were induced to engage in extraction behavior. The emergence and rapidly increasing level of corruption in China in the late 1980s was the result of Deng’s focus on private goods.

In the 1980s, Hu Yaobang and Zhao Ziyang worked as Deng’s “left and right hands,” (Wu, 2011) and together, they promoted market-oriented economic reforms. As the General Secretary of the CPC, Hu was also well-known for his political liberalism. Hu attempted to increase the transparency of the political system, (Becker, 2005) supported the rehabilitation of the people who were persecuted during the Cultural Revolution, and was in favor of Tibetans administering their own affairs. (The Australian, 2009)

However, Hu’s political liberalism was against the ideology of some senior Party members. In December 1986, a protest was organized by a group of students from the University of Science and Technology in Hefei, Anhui, in demand for greater political and economic liberalization. This protest spread over a dozen of cities. When Deng asked Hu to dismiss the leaders of these protests, Hu refused. (Lee, 2005) In January 1987, two weeks after these protests, senior Party and military members forced Hu to resign as the General Secretary of the CPC. (Kristof, 2011) Hu was replaced by Zhao Ziyang as the General Secretary of the CPC.

On the 13th Central Committee of the Communist Party of China, which was in session from 1987 to 1992, major restructuring of the members of the PSC took place. Hu was initially replaced by Zhao Ziyang as the number 1 ranked member of the PSC, and then in 1989, Zhao was replaced by Jiang Zemin. At the same time, all the senior
members of the PSC were replaced by younger members of the CPC. Ye Jianying, Deng Xiaoping, Li Xiannan, and Chen Yun on the 12th PSC were replaced by Li Peng, Hu Qili, Qiao Shi, and Yao Yilin on the 13th PSC. The 13th PSC has a total of 5 members. Even though Deng was taken out of the 13th PSC, he was still considered the de facto leader until he stepped down as Chairman of the CMC in 1989.

The major restructuring of the 13th PSC in 1987 significantly impacted the political atmosphere of China over the next several years. It is no coincidence that the June 4th 1989 crackdown took place two years after the restructuring of the 13th PSC. The changing political atmosphere started in 1987, when Hu Yaobang was forced to resign as the General Secretary of the CPC. As a reformer politician, Hu’s resignation has two implications. First, the removal of Hu means that the reformer faction was weakened in the PSC. Second, his removal upset the educated groups, particularly university students and intellectuals.

As a result of this changing political atmosphere, the Tiananmen Square student protests took place in 1989, triggered by the death of Hu Yaobang on April 15th, 1989. Student groups initially were gathered at Tiananmen Square to mourn the death of Hu Yaobang. This gathering soon turned into protests against the central government, and demands for faster economic and political reforms. Over the next few weeks, participants of these protests demanded non-violent negotiation with the central government.

With a weakened reform faction in the PSC, the central government refused to negotiate with the protestors. Even if Deng wanted to speed up the reform process at the time, to do so would be difficult due to a weakened reform faction. As a pragmatic
politician, Deng had to side with the conservative faction for his own political survival. Deng’s alliance with the conservative faction during the student protests was one of the contributing factors for Premier Li Peng to declare martial law on May 20th, and this event eventually caused the June 4th 1989 crackdown. After the crackdown, reform politician Zhao Ziyang was immediately dismissed, and was replaced by Jiang Zemin as the General Secretary of the CPC.

This historical event proves that factional competition within the core of China’s political system, the Politburo Standing Committee, determines the level of repression used by the CPC. As predicted by Mesquita and Smith in their model of dictatorship, a smaller sized winning coalition leads to a greater level of repression. (Mesquita and Smith, 2011) After the conservative faction in the PSC took down Hu and Zhao, it reduced the size of the winning coalition, allowing the conservative faction to utilize the military to repress the protestors. If Hu and Zhao were not taken down prior and during the Tiananmen Square protests, factional negotiation between the liberal faction and the conservative faction could have led to a peaceful compromise within the PSC, and this might have prevented the crackdown.

The effect of the Tiananmen Square crackdown resulted in a backward step toward economic and political freedom in China, lasting for almost 2 years, until Deng made the famous Southern Tour in early 1992. The series of events leading up to the Tiananmen Square crackdown, and the aftereffect, in terms of reduced economic and political freedom, reflected the significance of the PSC. A weakened liberal faction, after
the removal of Hu in January 1987 and Zhao in June 1989, strengthened the conservative faction.

During the 2 years after the Tiananmen Square crackdown, the central government, run by a strong conservative faction, re-established tight control over the media and the economy. Internationally, major commitments on foreign direct investment were cancelled, while foreign loans were suspended by the World Bank, Asian Development Bank, and other foreign government organizations. (Thakur, Burton, and Srivastava, 1997) In addition, defense spending rose significantly, from 8.6 percent in 1986 to 15.5 percent in 1990, thus reversing the decline of defense spending from the previous 10 years. (Kelley and Shenkar, 1993)

The turning point of China’s economic and political reversal took place when Deng made his famous southern tour in January 1992. During his southern tour, Deng stressed the importance of continued economic reform to China’s development. The national media, controlled by the conservative faction, initially ignored Deng’s southern tour. However, Jiang Zemin eventually sided with Deng and allowed the national media to report Deng’s southern tour, which then quickly gained the support of local officials.

Deng’s southern tour also coincided with the changing members of the 14th PSC from 1992 to 1997. Jiang Zemin, Li Peng, and Qiao Shi on the 13th PSC were also on the 14th PSC, while Hu Qili and Yao Yilin on the 13th PSC were replaced by Li Ruihuan, Zhu Rongji, Liu Huaqing, and Hu Jintao on the 14th PSC. An obvious change from the 13th PSC to the 14th PSC was an increase in the size of the winning coalition. The 13th PSC had 5 members while the 14th PSC had 7 members.
An increase in the winning coalition of the 14\textsuperscript{th} PSC from the 13\textsuperscript{th} PSC implies a greater focus of the top Chinese leaders in providing public goods over private goods. In addition, the removal of Hu Yaobang and Zhao Ziyang in the late 1980s proves that \textit{it is not just the absolute size of the winning coalition that matters, but more importantly, the relative size of the different factions within the winning coalition matters just as much if not more}, particularly under the Chinese political system where the marginal change in the size of the winning coalition is small.

Looking at the composition of the 14\textsuperscript{th} PSC, a new key member Zhu Rongji was added to the PSC, thus increasing the relative size of the liberal faction to the conservative faction of the winning coalition. Zhu served as the Mayor and Party chief in Shanghai between 1987 and 1991, and then served as the first Vice Premier of the State Council. During the Great Leap Forward, Zhu was labeled as “Rightist” for criticizing Mao Zedong’s economic growth policies. As the mayor of Shanghai, Zhu was well-known for his contribution to the development of Pudong special economic zone. In addition, Zhu refused, when under the pressure of hardliners, to declare martial law in Shanghai during the student protests in 1989. (MacFarquhar, 1994)

Zhu’s rise as the Vice Premier was endorsed by Deng for his liberal approach to economic development. Since Zhu was an expert of economic development, Zhu served as Jiang Zemin’s right hand man in tackling China’s major economic issues in the 1990s. Under a more balanced factional composition in the PSC in the 1990s, Zhu was able to make institutional reforms to the state-owned enterprises, accelerate the growth of the private sector, and steer China into the WTO in 2001.
After Jiang Zemin stepped down as the General Secretary of the CPC and President of China in November 2002, Hu Jintao succeeded Jiang as the next generation leader. This change in leadership also changed the composition of the 16th PSC from 2002 to 2007. The composition of the 16th PSC is different from the earlier PSCs in three aspects. All the members in the previous two PSCs, other than Hu Jintao, were replaced by new members in the 16th PSC. In addition, the members of the previous two PSCs were 7, while the members of the 16th PSC expanded to 9.

The factional composition change of the 16th PSC was the most important change from all the previous factional compositions since 1978. If all the previous PSCs were composed of the liberal faction and the conservative faction, then the 16th PSC was composed of the populist faction and the elitist faction. Factional change implies that the economic and political objects of the leaders headed by Hu Jintao would be different from the previous leaders headed by Deng Xiaoping and Jiang Zemin.

During the era of Deng and Jiang, factional competition between the liberal faction and the conservative faction was essentially a battle between the market and central planning, and the winner determined the market-oriented approach to China’s economic development. Factional competition between the populist faction and the elitist faction under Hu Jintao was not a battle between the market and central planning, instead, the battle was essentially between the rich and the poor. To understand this battle requires analyzing the differences between the populist faction and the elitist faction.

The populist faction, led by Hu Jintao and Wen Jiabao, consists of top officials who have risen to power from the grassroots of China’s power structure, usually
associated with the Communist Youth League. Members of the populist faction are usually more educated with university degrees or higher. As a result of their humble background, they represent the interests of the poor in the society, particularly in rural areas. For example, Hu and Wen both rose to power without strong political family privileges and spent many years working in China’s poorest areas before becoming important members of the central government in Beijing.

The elitist faction, on the other hand, is led by Jiang Zemin and Zeng Qinghong, and consists of top officials who came to power in connection with the Shanghai administration and princeling politicians who climbed the political ladder through the connections of their communist veteran parents. Therefore, members of the elitist faction usually have strong political family connections, and many originated from rich coastal provinces. As a result of their privileged background, they often represent the interests of the rich in the society, particularly in the coastal regions.

Looking at the factional composition of the 16th PSC from 2002 to 2007, the populist faction included General Secretary of the CPC and Chairman of the CMC, Hu Jintao, and Party Secretary of the State Council, Wen Jiabao. The elitist faction included Party Secretary of the Standing Committee of the NPC, Wu Bangguo, Party Secretary of the People’s Political Consultative Conference, Jia Qinglin, Secretary of the Secretariat of the CPC Central Committee, Zeng Qinghong, Deputy Party Secretary of the State Council of the PRC, Huang Ju, Secretary of the Central Commission for Discipline Inspection, Wu Guanzheng, Chairman of the CPC Central Guidance Commission for
Based on the factional composition above, the elitist faction controlled the 16th PSC. However, according to Cheng Li (2009), an analyst at the Brookings Institute, this imbalance of power at the top was balanced out by the populist faction holding more seats in the central committee. Mr. Li further states that “Populist coalition controls areas such as party organisation, propaganda, united front work, law, party discipline, and provincial leadership, while the Elitist coalition controls the economic administration, foreign trade and finance, foreign affairs, education, science and technology, military affairs and public security.” (Li, 2009)

As a result of this changing nature of China’s factional competition, China’s overall economic, social, and political focuses have dramatically changed course from the 1990s to the 2000s. On the economic and social dimensions, the populist faction focused on regional development to reduce the income gap between the coastal regions and the inland regions, labor migration patterns, and a harmonious society. Elitist faction, in contrast, focused on benefitting the entrepreneurs in the coastal regions, middle class in urban areas, and the economic interest of the princeling politicians. (Li, 2009)

As members of these two factions, they represent polarized economic interests for their constituents and their constituents provide them with economic benefits in return, resulting in factional competition in the economic dimension. As China’s economy grew rapidly over time, the growth also significantly expanded the size of the constituents that the two factions represent, either the actual size of the constituents, or the economic
values held by the existing constituents, or both. As a result of this increase, the wealth of these top politicians increased dramatically in the 2000s.

Significant increase in the wealth of the top leading officials in Beijing in the past decade was exposed in an article written by reporters at the Financial Times under the title “The Family Fortunes of Beijing’s New Few.” (Financial Times, 2012) According to the article, the nation’s wealth is concentrated in the hands of a few powerful political families, and they are made “fabulously wealthy while ignoring the rules of laws they set for the rest of society.” (Financial Times, 2012)

The article quoted a remark made by Professor Andrew Nathan of Columbia University, co-editor of *The Tiananmen Papers*, a collection of top-level decision-making documents of the Tiananmen Square student protests leaked out of China. “Powerful political families have come to control vast swaths of the Chinese economy in an environment where there is no separation of powers, no independent judiciary or media and the government sits astride everything.” (Financial Times, 2012)

Yang Jisheng, a veteran party member and journalist for state media organizations, explained in detail to the reporters of the Financial Times, how the children of government officials or pricelings used their political privileges to make huge personal economic gain. “Say your father is the provincial governor, one word from you might mean government approval for my real estate deal followed by several hundred million [renminbi], so what’s the big deal if I give you Rmb100m [$15.7m] back?” (Financial Times, 2012)
On the political dimension, the two factions seem to be more cooperative, rather than competitive, as on the economic dimension. On the political dimension, both factions have a shared interest, which is to sustain the political dominance of the CPC and to prevent any opposition that could potentially harm the political dominance of the CPC. Due to their shared political interest and the lack of major political opposition, they are less concerned about reforming China’s political system and improving individual political freedom. This cooperative political atmosphere allows the CPC to focus heavily on internet and media censorship, political and military suppression, and the persecution of human rights activists.

On a follow up article also written by the reporters of the Financial Times titled “China’s Powerful Families,” major business interests held by the immediate family members of China’s current and retired members of the PSC are exposed in detail. (Financial Times, 2012) Based on these two articles, a clear picture is provided of the changing nature of China’s elite political leaders and of how their family members seized control of a large portion of China’s economy.

Unconstrained money grabbing behavior of the power political families set a direct contrast to the period of the 1990s. “In the 1990s most senior leaders at least tried to moderate their princelings as they got rich but now there is almost no restraint and it has got out of control,” says a leading Chinese financier with close ties to the party leadership. (Financial Times, 2012) This phenomenon within the powerful political elites further proves Mesquita and Smith’s model of dictatorship. When the winning coalition reduces relative to the size of the selectorate, greater private benefits are allocated to the
members of the winning coalition. (Mesquita and Smith, 2011) As China’s economic pie grows significantly in size while the size of the winning coalition stays stable over time, members of the winning coalition in China gain significantly in private benefits.

In contrast, the liberal faction led by Hu Yaobang in the 1980s actually cared about individual political freedom and wished for a democratic political reform. Had Hu Yaobang succeeded in the factional competition between the liberals and the conservatives in the 1980s, the disastrous event of the June 4th 1989 crackdown may have been prevented from happening, and democratic political reforms may have taken place in the 1990s.

5. Xi Jinping’s Rise and Bo Xilai’s Dismissal During the 2012 Politburo Transition: Two Scenarios Assessing the Future of Political and Economic Freedom in China

Xi Jinping is the person in line to succeed Hu Jintao as General Secretary and President in the fall of 2012. He is currently the Vice President of China, Vice-Chairman of the CMC, first Secretary of the Central Secretariat of the CPC, President of the Central Party School, and the 6th ranked member of the Politburo Standing Committee of the CPC. What approach Xi will take toward China’s future economic and political environment once he comes into power is uncertain. Will Xi continue with China’s market-oriented economic reforms, and will he relax political control to bring greater political freedom to the citizens of China?

Using the model of dictatorship as criteria makes it possible to examine China’s political transition from the 17th PSC to the 18th PSC and assess how this transition would affect Xi’s behavior as China’s next generation leader. Will Xi be more repressive or less
repressive? In addition, the current dismissal of China’s top princeling politician, Bo Xilai, provides a perfect case study for analyzing the current change in China’s political atmosphere and evaluating how Bo’s downfall would affect Xi’s behavior once he comes into power.

Tracing Xi’s political root as a princeling politician is imperative in order to have an in-depth understanding of his political trait. As a princeling politician, Xi rose to the top of China’s political hierarchy through the connection of his father, Xi Zhongxun, a first generation communist veteran who served in the CPC as Vice-Premier, head of the CPC’s Propaganda Department, and Vice-Chairman of the NPC. In 1962, Xi’s father was purged from all leadership positions based on the accusation that he led an anti-party clique for supporting the Biography of Liu Zhidan. Liu was a Chinese military commander and was considered a martyr. When the Biography of Liu Zhidan was published in 1962, it was criticized as an anti-party conspiracy. Due to Xi Zhongxun’s involvement with this biography, he was demoted as a deputy manager of a tractor factory in Luoyang. (Cui, Wen, and Cui, 2004)

After the Cultural Revolution, Xi’s father was fully rehabilitated in December 1978 by Deng Xiaoping. Xi’s father served as the provincial secretary of the coastal province of Guangdong and political commissar of the Guangdong Military Region from 1978 to 1981. (Cui, Wen, and Cui, 2004) Xi’s father was elected deputy chair of the Standing Committee of the NPC in 1981 and was elected to the Politburo in September 1982. Xi’s father was considered one of the more liberal party leaders who proposed and implemented the first SEZ of Shenzhen.
As a princeling politician, Xi climbed the political ladder with relative ease, served in the provinces of Hebei and Shaanxi, in the rich coastal provinces of Fujian and Zhejiang, and in the city of Shanghai before he was appointed as a member of the 17th PSC. In addition to his father’s political connection, Xi’s personal political milestone came when he was appointed as the Party Secretary of Shanghai in March 2007, replacing Chen Liangyu, who was involved in a social security fund scandal. As the Party Secretary of Shanghai, Xi also belongs to the Shanghai clique headed by Jiang Zemin. Both the members of the princeling faction and the members of the Shanghai clique belong to the elitist faction. So essentially, Xi belongs to the elitist faction with a duo connection to both the princeling faction and the Shanghai clique.

His unique duo factional connection reflects the spectrum of economic and political interests Xi represents for his constituents. The princeling faction consists of the children of revolutionary leaders who are currently the beneficiaries of significant political and economic privileges. The extended family members of these princeling politicians usually possess large business interests, and the children of these princelings often attend elite, private universities in the West and drive expensive sports cars.

A recent article published by the Bloomberg News exposed the business stakes held by the extended family of Xi. “Those interests include investments in companies with total assets of $376 million; an 18 percent indirect stake in a rare-earths company with $1.73 billion in assets; and a $20.2 million holding in a publicly traded technology company. The figures don’t account for liabilities and thus don’t reflect the family’s net worth.” (Bloomberg News, 2012) Interestingly, none of these assets can be traced
directly to Xi; instead, these assets are traced to Xi’s older sister Qi Qiaoqiao and her husband Deng Jiagui.

After Xi succeeds Hu in the fall of 2012, he will be considered the head of the princeling faction. Xi’s unique role as the head of the princeling faction and a member of the Shanghai clique brings an additional layer of complexity into the 18th PSC. Once Xi becomes the number one ranked member of the 18th PSC after succeeding Hu, his forthcoming political status would strengthen the political status of the princeling faction within the elitist faction. The elitist faction that was once dominated by the Shanghai clique would have to share its political power more equally with the princeling faction. The strengthening of the princeling faction in the PSC would bring additional competition in the PSC, and would transform China’s current “bipartisan” political competition (elitist vs. populist) into a “multi-partisan” political competition among the Shanghai faction, the princeling faction, and the populist faction.

The nature of bipartisan political competition is different from the nature of multi-partisan political competition. Bipartisan competition on the one hand, leads to direct competition between two competing groups. Multi-partisan competition on the other hand, leads to coalition among groups. With three competing groups, two groups would have to form into a coalition to gain a competitive advantage over the third group.

As in the case with China, Xi’s political background in both the princeling faction and the Shanghai clique would further strengthen the coalition between these two factions rather than weaken their tie under multi-partisan competition. Once Xi stepped into the 18th PSC as the number one ranked member, his top political priority would have to be
protecting the political and economic interests of the princeling faction while preserving
the political and economic interests of the Shanghai clique.

Even if the tie between the princeling faction and the Shanghai clique grows
stronger due to “multi-partisan” competition, this political structure would still be more
competitive than the “bipartisan” competition. If the model of dictatorship is applied,
increasing the competition in the PSC from the “bipartisan” system of the 16th PSC and
the 17th PSC to the “multi-partisan” system of the 18th PSC would create a similar effect
as an increase in the size of the winning coalition, even though the actual size of the
winning coalition (9 members of the PSC) would remain the same.

The “multi-partisan” system in the PSC would reduce the profit margin each
individual member gains through increased competition and increased political check and
balances. The term profit in this case means economic or monetary profit received from
the constituents in exchange for political support. Increased competition and increased
political check and balances would reduce individual power, which means the elite
politicians are now less able to bring political benefit to their constituents; as a result,
they receive less economic or monetary profit in return.

If this is the case, then the elite politicians in China would have to provide greater
public goods to the citizens of China. With less individual political power and less profit
margin to gain, increasing their political assets through other channels makes more sense.
Therefore, one of the alternatives to increasing their political assets is to increase their
public image by increasing the spending on public goods at the margin, which would
result in an overall increase of social benefits in China.
Besides Xi’s unique political background, the recent downfall of Bo Xilai could also strengthen ties between the princeling faction and the Shanghai clique. Like Xi, Bo is also a princeling politician whose father is Bo Yibo, one of the Eight Elders of the CPC. Through his father’s political connection, Bo came into power as the mayor of the coastal city Dalian and then the governor of Liaoning Province. Bo served as Minister of Commerce from 2004 to 2007, and then as Secretary of Chongqing Committee and a member of the Politburo from 2007 to 2012.

As the head of the Chongqing Committee, Bo is known for his “Chongqing Model,” including tough anti-corruption campaigns, heavy-handed attacks against organized crime, increased spending on welfare programs, and revival of Maoist ideology through his “Red Songs” campaign. Bo was considered a likely candidate for the 18th PSC before his political downfall after the Wang Lijun incident in February 2012.

Wang Lijun was the vice-mayor and head of the Public Security Bureau of Chongqing, and was credited for cracking down on corruption and organized crime. On February 2012, Wang arranged a meeting at the U.S. consulate in Chengdu and remained in the consulate for approximately 24 hours. He was demoted from his posts after he sought asylum at the American consulate and revealed details of Bo and his wife, Gu Kailai’s alleged involvement in the murder of British businessman Neil Heywood. (Lafraniere, Burns, and Ansfield, 2012)

As a result of Wang Lijun’s incident, Bo was dismissed as Chongqing party chief on March 15th 2012. The decision for Bo’s dismissal was reportedly made at the meeting of PSC on March 7th. Among the 9 members of the PSC, only Zhou Yongkang, the chief
of China’s security forces and law enforcement institutions, voted against Bo’s dismissal. (Ansfield and Johnson, 2012) On March 14th, Wen Jiaobao condemned Bo and the Chongqing administration during Premier’s annual conference. Wen also warned about going back to the “red culture” and detrimental effect of the Cultural Revolution. (Analects, 2012)

Bo was later suspended from the 25 members Politburo of the CPC on April 10th for “serious disciplinary violations,” and Bo’s wife has been convicted of the murder of Neil Heywood. (Buckley and Lim, 2012) Not only did Bo’s political career end, but his close ally, Zhou Yongkang was also affected. According to the Financial Times on May 13th, 2012, Zhou has “relinquished day-to-day control of the country’s police, courts and spy networks in the wake of the most serious political scandal to hit the country in decades, according to senior Communist party members.” (Anderlini, 2012)

However, The New York Times, a few days later on May 19th, 2012, reports that the Xinjiang Daily, a state-run newspaper, announced during Zhou’s western tour that Mr. Zhou has been “unanimously elected” as a member of the Xinjiang delegation to the 18th Party Congress in the fall of 2012. (Wong, 2012) Therefore, it is unclear at this point how Zhou is affected by Bo Xilai’s political scandal. Whatever the situation is with Zhou, what is more important is the implications of Bo’s downfall to China’s political transition from Hu to Xi.

The downfall of the princeling politician Bo Xilai not only weakened the existing princeling faction, it also proves that the populist faction led by Hu Jintao and Wen Jiabao is becoming stronger, or at least they are strong enough to weaken the princeling
faction. This political turmoil puts direct pressure on the princeling faction and indirect pressure on the Shanghai clique. As a result, it makes even more political sense for these two factions to strengthen their ties to counteract the political strength of the populist faction.

Another political implication to Bo’s downfall is that the “Chongqing Model” of reviving Mao Zedong’s “red culture” is no longer feasible. Bo’s dismissal under the consensus of the existing members of the PSC proves that the “red culture” is no longer popular among the elite politicians; therefore, its revival under effort of the few would not receive enough political support. On this aspect, the unlikelihood of stepping backward into the “red culture” can be considered a small political improvement in itself, even if political freedom does not improve in the near future.
CHAPTER 7: CHINA IN TRANSITION: THE FUTURE OF CHINA’S ECONOMIC AND POLITICAL REFORMS

1. Introduction

On November 15, 2012, Xi assumed the post of General Secretary of the Communist Party of China (CPC) and the Chairman of the CPC Central Military Commission. The new members of 18th Politburo Standing Committee (PSC) headed by Xi were also revealed on November 15. The number of members shrank from 9 members of the previous PSC to 7 members of the current PSC.

Even though China experienced a smooth leadership transition from Hu Jintao to Xi Jinping at the 18th National Congress in early November, it is uncertain at this point whether the new leadership will take a reform oriented path or maintain the current status quo. However, one thing is certain: China is at an economic and political crossroads, where China’s internal political struggle and increased government intervention on the economy exerts tremendous friction to China’s economic development.

On the political front, the recent downfall of Chongqing’s party chief, Bo Xilai, revealed China’s intensified political struggle within the Politburo. Around the time that Bo was dismissed from his posts in late March, it was rumored that Zhou, the head of China’s domestic security, attempted a coup. The Wall Street Journal reported on March 22, 2012 that China’s wildly popular microblogging sites blogged about gunfire in downtown Beijing and the political struggle inside the Zhongnanhai leadership
compound in downtown Beijing. One popular theory is a political struggle between Zhou Yongkang and Hu Jintao, Wen Jiabao, and other members of the PSC who supported Bo’s dismissal led to an attempted coup by Zhou. (Chin and Spegele, 2012)

Whether the attempted coup did actually occur or not is unknown. However, it is not hard to see the potential threat Zhou brings to the cohesion of the politburo based on the rapid increase in the spending on domestic security forces in recent years. It was announced at the annual session of the National People’s Congress on March 6, 2012, before Bo’s downfall, that China will increase its spending on domestic security forces by 13.8 percent from last year to 111.4 billion US dollars. This spending increase even surpassed its military spending in 2012 of 106.4 billion US dollars. (Reuters, 2012)

On the economic front, recent decline in China’s GDP growth signaled that the current leadership is losing its grip in manipulating China’s economic growth. Two interacting forces are at play in China’s declined GDP growth. On the one hand, this economic decline is contributed to by the overall global economic decline, which reduced the demand for China’s exporting goods and services. On the other hand, increased government intervention in China’s domestic market reduced economic freedom. Reduced economic freedom translates into reduced efficiency in the allocation of capital and financial resources, which makes China’s past rapid economic growth unsustainable.

The combination of political struggle and declined economy influenced the Communist Party of China (CPC) to tighten its control over the society via increased repression and media censorship in order to ensure the stability of the Party and the society as a whole. According to Sun Liping, a professor of sociology at Beijing’s
Tsinghua University, an estimated number of 180,000 protests or riots occurred in 2010, from small-scaled peaceful protests to large-scaled murderous riots. This number doubled from 90,000 in 2006, as estimated by the Chinese Academy of Social Sciences. 

(Forsythe, 2011)

The recent decline in China’s political and economic freedom indexes, as measured by various major non-governmental organizations, displayed statistical evidence to China’s worsened political, economic, and social conditions. Whether the CPC is able to solve these critical political, economic, and social problems depends largely on the decision-making of the new leaders to be headed by Xi Jinping. Their response to these critical political, economic, and social problems will determine China’s reform path in the coming years.

2. China’s Economic Freedom Indexes

To understand the severity of China’s worsened political, economic, and social conditions in the recent years, it is imperative to take a close look at economic freedom indexes measured by various major non-governmental organizations. The annual indictors that are widely used are Economic Freedom of the World (EFW) indexes produced by the Fraser Institute and Index of Economic Freedom (IEF) produced by The Heritage Foundation and The Wall Street Journal. These two indexes attempt to measure the degree of economic freedom in the world’s nations.

Economic freedom is a major contributing factor to a nation’s economic development. Greater economic freedom translates into less government intervention and better economic institutions, resulting in higher growth driven by market forces. The
positive impact of economic institutions on economic growth is presented in the theoretical framework and empirical work by economists Acemoglu, Johnson, and Robinson (2004), showing that economic institutions are the fundamental cause in explaining the differences in economic development (Acemoglu, Johnson, and Robinson, 2004) More specifically, in the case of China’s modern economy, fiscal decentralization, institutional reform of state-owned enterprises (SOEs), China’s accession to the WTO, and other institutional reforms all contributed to China’s rapid economic growth in the past 3 decades.

The EFW indexes measure the degree of economic freedom of countries in terms of their economic policies and institutions. The key ingredients of economic freedom are personal choice, voluntary exchange, freedom to compete, and security of privately owned property. The EFW indexes are measured in five major areas, including size of the government, legal system and security of property rights, sound money, freedom to trade internationally, and regulation. (EFW, 2012)

Size of a government determines the level of government spending and intervention. A bigger government size increases the dependence on political process to allocate resources, and goods and services. Signs of an increased government size include but are not limited to increased transfers and subsidies as a share of GDP, increased government spending, increased government investment relative to private investment, etc. (EFW, 2012)

Legal system and property rights determine the protection of persons and their property. A well-established property rights system results in more efficient allocation of
resources, which promotes economic growth. The enforcement of property rights requires a good legal system, with rule of law, independent judiciary, and impartial court system.

Sound money is a factor in determining gains from trade. As Friedman observes, inflation is a monetary phenomenon, in that high rates of monetary growth lead to inflation, which distorts relative prices. (EFW, 2012) The freedom to trade internationally is another factor in determining gains from trade. On the global scale, increased global interaction results in many goods and services being produced from abroad. Government intervention on trade, including tariffs, quotas, and exchange rate manipulation reduces the gains from trade. Lastly, regulations that restrict the free entry into markets reduce the freedom to engage in voluntary exchange, which also hinder gains from trade.
Table 32 Chain-linked & Unjusted Ratings and Rankings (1980-2010)

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Table 1 represents chain-linked and unadjusted ratings and rankings of China’s economic freedom between 1980 and 2010 from EFW. This table provides an overall rating, rating in each of the five categories, and specific ratings in the subcategories under the five categories. Each rating is from 0 to 10, and a higher value means greater economic freedom. The numbers inside the parentheses represent China’s economic freedom ranking among the 144 countries. Rating values determine China’s economic freedom in absolute terms, whereas ranking numbers determines China’s economic freedom relative to the 144 countries. Therefore, it is more meaningful to look at the ranking numbers in analyzing China’s changing economic freedom relative to other countries.

Based on the overall ranking numbers, the average of the five areas, China’s economic freedom relative to other countries stayed the same between 2000 and 2010, which ranked China in 100th place. This data shows that given China’s increased global trade interaction and rapid economic growth over the last decade, little impact was made on China’s economic freedom. Looking specifically at each of the broad five areas between 2000 and 2010 and their subcategories in Table 1, China’s economic freedom ranking increased in some areas but decreased in other areas. Size of government ranking decreased from 115 in 2000 to 121 in 2010, which means that China’s economy increased its dependence on the political process to allocate resources. Looking more closely at the subcategories under size of government, increased government consumption was the driving factor in the increased size of government, which also explains the increased level of government corruption.
Legal system and property rights ranking increased significantly from 79 in 2000 to 67 in 2010, which means that the Chinese government increased the protection of individuals and their rightfully acquired property. However, looking more closely at the subcategories under legal system and property rights, the level of military interference in rule of law and politics has increased significantly. Increased level of military interference has the potential to distort China’s legal system and the protection of property rights.

Sound money ranking decreased significantly from 56 in 2000 to 82 in 2010, which means that inflation rates became more volatile through Chinese government’s increased monetary manipulation. Freedom to trade internationally ranking increased slightly from 77 in 2000 to 74 in 2010, which means that the Chinese government made a minimum effort in reducing trade restrictions and exchanging rate control. However, looking more closely at the subcategories under freedom to trade internationally, the Chinese government increased its control on the flow of capital and restrictions on people’s mobility. Regulation ranking increased from 92 in 2000 to 77 in 2010. However, looking more closely at the subcategories under regulation, the Chinese government significantly increased its administrative requirements on businesses, which implies that it became more costly for businesses in China to operate.

Similar to the EFW indexes, the IEF indexes measure the degree of economic freedom of countries in terms of property rights, freedom from corruption, fiscal freedom, government spending, business freedom, labor freedom, monetary freedom, trade freedom, investment freedom, and financial freedom. These ten factors of economic
freedom are broadly categorized into rule of law, limited government, regulatory efficiency, and open markets. (IEF, 2012)

Under rule of law, a well-established private property rights structure motivates workers and investors, which is an essential feature of a market economy. To ensure the functioning of private property rights, an effective judicial system is necessary. In addition to private property rights, freedom from corruption is another attribute of rule of law. In general, corruption is the result of lack of integrity in the political system. Without an effective monitoring and punishment system, politicians would use their political power for personally gain at the expense of the whole. Political corruption takes on various forms, including bribery, extortion, nepotism, cronyism, patronage, embezzlement, and graft. (IEF, 2012)

Under limited government, the size of a government is determined by the degree of fiscal freedom and the amount of government spending. Fiscal freedom measures the extent that individuals and businesses have control over their wealth and income. Fiscal freedom is reduced with increased taxation, because taxation reduces the wealth and income level of individuals and businesses. The degree of fiscal freedom is also correlated with the amount of government spending, because government spending must be paid off through taxation, which leads to reduced fiscal freedom. In addition, government spending directly crowds out private economic activities, by distorting the allocation of resources and private investment incentives. (IEF, 2012)

Under regulatory efficiency, efficiency is measured by business freedom, labor freedom, and monetary freedom. Business freedom is the right of individuals to establish
enterprise without government interference. Government interference can increase the barrier of entry and the cost of production. Labor freedom is the right of individuals to work and to establish a contractual relationship with their employers. Labor freedom is reduced by labor regulations, wage control, restrictions on hiring and firing, and restrictions on labor mobility. Monetary freedom is determined by the stability of currency in the economy. An unstable currency is the result of inflationary policy, which distorts prices. A stable currency on the other hand, increases the certainty of long-term plans of investments and savings. (IEF, 2012)

Under open markets, the openness of a market is determined by trade freedom, investment freedom, and financial freedom. The degree of trade freedom is measured by trade restrictions, including tariffs, export taxes, and trade quotas. Increase in trade restrictions reduces trade freedom. Investment freedom is the ability of enterprises to mobilize capital, both domestically and internationally. A reduction in investment freedom reduces the efficient allocation of resources. Financial freedom ensures the fairness of enterprises in accessing capital, instead of strategically limiting financial resources to large or important companies. In addition, an open banking market with limited government interference promotes financial competition, which enhances the efficient allocation of financial resources. (IEF, 2012)

Table 2 represents ten economic freedom indexes in China in 2012. IEF scores a country’s economic freedom from 0 to 100 and ranks the country among 184 countries. A higher score represents a higher degree of freedom, while a lower rank (higher number) represents a lower degree of freedom among countries. Rank is a more meaningful
measure of China’s economic freedom because it measures China’s economic freedom relative to all other countries. More importantly, the IEF’s ten indexes of economic freedom of China in Table 2 should be analyzed in comparison with EFW’s indexes of economic freedom of China in Table 1. The comparative analysis would paint a more precise picture of China’s economic freedom ranking in the world.

In term of China’s overall economic freedom ranking, the IEF ranked China at 138\textsuperscript{th} place, much lower than the 100\textsuperscript{th} place ranked by EFW. The reason for IEF’s lower rank requires an in-depth analysis of each of the ten economic freedom indexes shown in Table 2.
Table 33 Ten Economic Freedom Indexes in China 2012

**THE TEN ECONOMIC FREEDOMS**

<table>
<thead>
<tr>
<th>RULE OF LAW</th>
<th>Country</th>
<th>World Average</th>
<th>Rank</th>
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</thead>
<tbody>
<tr>
<td>Property Rights</td>
<td>20.0</td>
<td></td>
<td>143rd</td>
</tr>
<tr>
<td>Freedom from Corruption</td>
<td>35.0</td>
<td></td>
<td>80th</td>
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</table>

China’s weak judicial system is highly vulnerable to political influence and corruption. All land is state-owned. Individuals and firms may own and transfer long-term leases that are subject to many restrictions. Intellectual property rights are not protected effectively, and infringements on copyrights, patents, and trademarks are quite common. Various forms of corruption severely affect banking, finance, government procurement, and construction.

<table>
<thead>
<tr>
<th>LIMITED GOVERNMENT</th>
<th>Fiscal Freedom</th>
<th>Government Spending</th>
<th>Rank</th>
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<tr>
<td></td>
<td>70.4</td>
<td>84.1</td>
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<td>35th</td>
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The top income tax rate is 45 percent, and the top corporate tax rate is 25 percent. Other taxes include a value-added tax (VAT) and a real estate tax. The overall tax burden is equal to 17.5 percent of total domestic income. Government spending has been expanding, with central government spending now equivalent to 23 percent of GDP; off-budget obligations are extensive. Reported central government debt has increased to 33.8 percent of GDP.

<table>
<thead>
<tr>
<th>REGULATORY EFFICIENCY</th>
<th>Business Freedom</th>
<th>Labor Freedom</th>
<th>Monetary Freedom</th>
<th>Rank</th>
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<td>55.4</td>
<td>74.2</td>
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<td>112th</td>
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</table>

The overall regulatory framework remains complex, arbitrary, and uneven. The time and cost to start a business exceed world averages, and the cost of completing licensing requirements is over four times the level of average annual income. The labor regime remains repressive, although the labor law introduced in 2008 allows employees more contractual rights. Inflation has been monitored intensely, with the government often relying on price controls.

<table>
<thead>
<tr>
<th>OPEN MARKETS</th>
<th>Trade Freedom</th>
<th>Investment Freedom</th>
<th>Financial Freedom</th>
<th>Rank</th>
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</thead>
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<tr>
<td></td>
<td>71.6</td>
<td>25.0</td>
<td>30.0</td>
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<td>132nd</td>
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</table>

The trade weighted tariff rate is 4.2 percent, with layers of non-tariff barriers adding to the cost of trade. The investment regime is non-transparent and inefficient. The state controls its tight control of the financial system as its primary means for managing the rest of the economy. The government owns all large financial institutions, which lend according to state priorities and directives and favor large state enterprises.

**Score Changes**

<table>
<thead>
<tr>
<th>RULE OF LAW</th>
<th>LIMITED GOVERNMENT</th>
<th>REGULATORY EFFICIENCY</th>
<th>OPEN MARKETS</th>
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<tr>
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<td>Freedom from Corruption</td>
<td>-1.0</td>
<td>-2.9</td>
<td>0</td>
</tr>
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</table>

Under the rule of law category, the IEF ranks China’s freedom on property rights at 143rd place and freedom from corruption at 80th place, while the EFW ranks China’s overall legal system and property rights at 67th place, which aggregates measures of judicial independence, impartial courts, protection of property rights, military interference in rule of law and politics, integrity of the legal system, legal enforcement of contracts, regulatory restrictions on sale of real property, reliability of police, and business costs of crime. The IEF’s ranking on China’s rule of law is much lower than the EFW’s ranking.

There are several reasons that the much lower ranking calculated by IEF makes more sense. First, since all land in China is state-owned and individuals only have contractual rights, China has very little freedom on land. In addition, intellectual property rights are not effectively protected, which leads to infringements on copyrights, patents, and trademarks.

Under the limited government category, the IEF ranked China’s fiscal freedom at 132nd place and freedom on government spending at 35th place, while the EFW ranked China at 121st place based on the overall size of government, which combines the measures of government consumption, transfers and subsidies, government enterprises and investment, and top marginal tax rate. Since the IEF’s ranking has polarized results, lower fiscal freedom relative to the world and much higher constraint on government spending relative to the world, it is difficult to make a direct comparison to the EFW’s ranking on China’s overall size of government. Instead of comparing the two indicators, two things are certain regarding the size of government.

261
In term of fiscal freedom, the degree of fiscal freedom in China stayed stable, with the top income tax rate of 45 percent, and the top corporate tax rate of 25 percent. However, government spending has been expanding, increasing to 23 percent of GDP this year, probably as a result of China’s slowed GDP growth. This increase in government spending increases the allocation of resources to the less efficient government and reduces private investment incentives.

Under the regulatory efficiency category, the IEF ranks China’s regulatory efficiency separately on business freedom, labor freedom, and monetary freedom, while the EFW ranks China’s overall regulatory freedom, which aggregates the measures of business freedom, labor freedom, and monetary freedom. The IEF ranks China’s business freedom at 149th place, labor freedom at 115th place, and monetary freedom at 112th place. The EFW ranks China’s overall regulatory freedom at 77th place in 2010. From these ranks, it is clear that China’s regulatory freedom is ranked much lower by the IEF.

The IEF justifies their low ranking using the terms complex, arbitrary, and uneven in describing China’s regulatory efficiency. More specifically, the IEF determined that the time and cost to start a business in China exceeds the world averages, while the cost of completing licensing requirements is over four times the level of average annual income. In addition to the barriers to entry, China’s labor regime remains repressive, while the central government relies heavily on price controls. (IEF, 2012)

Under the open market category, the IEF ranks China’s openness in the markets separately on trade freedom, investment freedom, and financial freedom, while the EFW ranks China’s overall freedom to trade internationally, which aggregates the measures of
tariffs, regulatory trade barriers, black-market exchange rates, and controls of the movement of capital and people. The IEF ranks China’s trade freedom at 119th place, investment freedom at 146th place, and financial freedom at 132nd place. The EFW ranks China’s openness to trade internationally at 74th place in 2010. From these ranks, it is clear that China’s openness in markets is ranked much lower by the IEF.

The IEF justifies their low ranking based on the measures of tariffs and government intervention in the financial system. More specifically, the IEF determined that not only is the trade weighted tariff rate in China 4.2 percent, trade becomes even more costly with additional layers of non-tariff barriers. In addition, the investment process in China is non-transparent and inefficient. More severely, heavy handed intervention is used by the central government of China in the financial system by owning large financial institutions in order to have control over the rest of the economy. As a result of state ownership in the financial system, the central government is able to prioritize lending through preferential treatment, usually favoring large state enterprises. (IEF, 2012)

3. China’s Political Freedom Indexes

The analysis of China’s economic freedoms is only one piece of the puzzle in understanding China’s overall freedom condition. Political freedom in China is another piece of the puzzle that must be analyzed in-depth. Putting these two pieces of the puzzle together is imperative in judging China’s overall freedom condition in the current time. Political freedom, like economic freedom, is a broad term that covers many aspects of freedom. Therefore, the analysis here breaks down political freedom based on the various
indexes produced by the Freedom House, which measures political freedom in terms of political rights, civil liberties, freedom of the press, and freedom on the net.

Political freedom and economic freedom are inter-connected, a move toward a more politically free structure often occurs either shortly before or shortly after economic reforms. (EFW, 2012) Political freedom, at the fundamental level, is the absence of interference of an individual via the use of coercion or aggression, particularly being free from government oppression. John Locke, widely known as the Father of Classical Liberalism, states in his “Two Treaties of Government,” that in a natural state, individuals have the natural right to defend their “life, health, liberty, or possessions.” (Locke, 1690)

A worldwide benchmark of political freedom is the Constitutions of the United State and the Bill of Rights, which are the guiding principles to individual freedom and to limiting the power of the U.S. government. The Bill of Rights is the collective name for the first ten amendments to the U.S. Constitution. It was established to protect the natural rights of people’s liberty and their property. More specifically, the key issues in the Bill of Rights are the right to vote, the freedom of assembly, the freedom of speech, and the protection from unreasonable search and seizure.

The Freedom House is a U.S.-based non-governmental organization that promotes and conducts research on the issues of political freedom and human rights. The Freedom House produces annual reports of Freedom in the World (FIW), Freedom of the Press (FOTP), and Freedom on the Net (FOTN), which assess political freedom, civil liberty, openness of the press, and openness on the internet among all the nations in the world.
The FIW report evaluates the improvement and decline of a country’s freedom under two broad categories, political rights and civil liberties, which are derived from relevant portions of the Universal Declaration of Human Rights. Political rights are measured based on the factors of electoral process, political pluralism and participation, functioning of government. Civil liberties are measured based on the factors of freedom of expression and belief, association and organizational rights, rule of law, and personal autonomy and individual rights. (FIW, 2012)

The FIW report assigns an overall numerical rating from 1 to 7 (most free to least free) for each of the 195 countries. An overall rating between 1 and 2.5 for a country is considered free, an overall rating between 3 and 5 for a country is considered partly free, and an overall rating between 5.5 and 7 for a country is considered not free. The overall rating for a country is determined based on individual ratings from 10 political rights questions and 15 civil liberties questions. Each country receives 0 to 4 points (least free to most free) on each question, with the total possible points of 100. The average of individual ratings determines the overall rating of 1 to 7. (FIW, 2012)

Based on the 10 political rights and 15 civil liberties questions, the FIW report rates China 7 points in political rights and 6 points in civil liberties, so the overall freedom rating on China is 6.5 points. Freedom rating of 6.5 points is a very low number on the freedom scale, and this freedom rating of 6.5 has not changed over the past 10 years. A description of China’s current key conditions in political rights and civil liberties is presented in Table 3.
Like China’s economic freedom, China’s rapid economic growth and accession to the WTO had little impact on China’s progress toward a more politically free state. If anything, China’s rapid economic growth has negatively impacted China’s progress toward a more politically free state. This backwardness in China’s political freedom is determined by the FIW report, and is represented by the downward trend arrow assigned to China’s condition in political rights and civil liberties. According to the FIW report, China received a downward trend arrow as a result of “increased Communist Party efforts to restrict public discussion of political, legal, and human rights, issues, including through the systematic disappearance of dozens of leading social-media activists and lawyers and growing online censorship among domestic social-networking services.” (FIW, 2012)

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<tr>
<th>Key Conditions of Political Rights</th>
<th>Country</th>
<th>Description</th>
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<tr>
<td>Electoral Process</td>
<td>China</td>
<td>Not an electoral democracy. The CPC has a monopoly on political power, and its nine-member Politburo Standing Committee sets government policy. Party members hold almost all top posts in the government, military, and internal security services, as well as in many economic entities and social organizations. The 3,000-member National People’s Congress (NPC), which is elected for five-year terms by subnational congresses, formally elects the state president for up to two five-year terms, and confirms the premier after he is nominated by the president. However, the NPC is a largely symbolic body. Only its standing committee meets regularly, while the full body convenes for just two weeks a year to approve proposed legislation.</td>
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</table>
| Political Pluralism and Participation | China | Opposition groups like the China Democracy Party (CDP) are suppressed, and members are imprisoned. Democracy advocate and 2010 Nobel Peace Prize winner Liu Xiaobo remained in prison in 2011, having been sentenced in December 2009 to 11 years for his role in creating the prodemocracy manifesto Charter 08. The San Francisco—
Based on the Dui Hua Foundation's estimates, 1,045 new arrests for "endangering state security" were made in 2010, and over 10,000 people have been arrested and indicted for such political crimes since 1997. Tens of thousands of other people are thought to be held in extrajudicial forms of detention for their political or religious views.

### Key Conditions of Civil Liberties

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<tr>
<th>Functioning of Government</th>
<th>Corruption remains endemic despite increased government antigraft efforts, generating growing public resentment. Each year tens of thousands of officials are investigated and punished by government or CCP entities, but prosecution is selective, with informal personal networks and internal CCP power struggles influencing the choice of targets. One of the most prominent cases of 2011 was the arrest of Railroads Minister Liu Zhijun on corruption charges in February, just a few months before a high-speed train crash in July that left 40 people dead and hundreds injured, sparking public outrage as efforts were made to cover up the cause.</th>
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<tr>
<td>Freedom of Media</td>
<td>Despite relative freedom in private discussion and citizens’ efforts to push the limits of permissible speech, China’s media environment remains extremely restrictive, and 2011 featured one of the worst crackdowns on freedom of expression activists in recent memory. According to international watchdog groups, China jailed 27 journalists in 2011, including many Uighurs and Tibetans. At least 70 online activists remained behind bars at year’s end for disseminating proscribed information, though the actual number was likely much higher. Local officials continue to block, harass, and sometimes assault foreign reporters while intimidating their Chinese sources and assistants. Some international radio and television broadcasts, including the U.S. government–funded Radio Free Asia, remain jammed. China’s population of internet users, estimated at over 500 million in 2011, remained the world’s largest. However, the government maintains an elaborate apparatus for censoring and monitoring internet and mobile-telephone communications. The authorities block websites or force deletion of content they deem politically threatening, and detain those who post such information. Although Twitter remains blocked in China and domestic microblogging services engage in government-directed censorship of certain political and social issues, the domestic services have grown rapidly in influence as a source of news and an outlet for public opinion, with the number of Chinese microblog users surpassing 200 million in 2011.</td>
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<tr>
<td>Religious Freedom</td>
<td>Religious freedom is sharply curtailed, and religious minorities</td>
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</table>
remained a key target of repression during 2011. All religious groups must register with the government, which regulates their activities and guides their theology. Some faiths, such as Falun Gong and certain Buddhist and Christian sects, are forbidden, and their members face harassment, imprisonment, and torture. Other unregistered groups, such as unofficial Protestant and Roman Catholic congregations, operate in a legal gray zone, and state tolerance of them varies from place to place. Beginning in April, hundreds of members of the Shouwang church in Beijing were briefly detained or placed under house arrest after they sought to gather outside because the owner of their place of worship had reportedly been pressured not to allow them to meet. In May, a vice president of the unregistered Chinese House Church Alliance was sentenced to two years in a labor camp.

<table>
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<tr>
<th>Academic Freedom</th>
<th>Academic freedom remains restricted with respect to politically sensitive issues. The CCP controls the appointment of university officials, and many scholars practice self-censorship to preserve their positions and personal safety. Political indoctrination is a required component of the curriculum at all levels of education.</th>
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<tr>
<td>Freedom of Assembly, Demonstration, and Open Public Discussion</td>
<td>Freedoms of assembly and association are severely restricted. In early 2011, hypervigilant security forces swarmed the locations proposed in anonymous, online calls for Tunisian-style prodemocracy protests, and no such demonstrations took place. Local officials face penalties if they fail to limit the flow of petitioners traveling to Beijing to report injustices to the central government. As a result, petitioners are routinely intercepted, harassed, detained in illegal “black jails,” or sent to labor camps. Detained petitioners are reportedly subject to beatings, psychological abuse, and sexual violence.</td>
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<tr>
<td>Freedom of Nongovernmental Organizations</td>
<td>Nongovernmental organizations (NGOs) are required to register and follow strict regulations, including vague prohibitions on advocating non-CCP rule, “damaging national unity,” or “upsetting ethnic harmony.” Groups seeking more independence organize informally or register as businesses, though they are vulnerable to closure at any time. In December 2011, authorities banned the unregistered Guizhou Human Rights Forum, which had organized discussions on human rights topics, shortly after detaining 11 members. Forum member Chen Xi was sentenced to 10 years in prison for his activism and online writings.</td>
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<tr>
<td>Effective Collective Bargaining via Unions and Organizations</td>
<td>The only legal labor union is the government-controlled All-China Federation of Trade Unions. Collective bargaining is legal but does not occur in practice, and independent labor leaders are harassed and jailed. Nevertheless, workers have increasingly asserted themselves informally via strikes, collective petitioning, and selection of negotiating representatives.</td>
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<tr>
<td>Independent Judiciary</td>
<td>The CCP controls the judiciary and directs verdicts and sentences, especially in politically sensitive cases. Even in commercial litigation and civil suits involving private individuals, previous minor progress</td>
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toward the rule of law has stalled or been reversed, particularly since the appointment of a CCP veteran with no formal legal training as chief justice in 2008. Judges have been increasingly pressured to resolve civil disputes through mediation, sometimes forced, rather than actual adjudication.

**Rule of Law in Civil and Criminal Matters**

The government continued its crackdown on civil rights lawyers, law firms, and NGOs offering legal services in 2011. Many of those abducted and abused in the Jasmine Revolution–related crackdown were lawyers, some of whom had previously faced disbarment for taking human rights cases. Prominent lawyer Gao Zhisheng remained “disappeared” and at severe risk of torture following his abduction by security forces in 2009. Self-trained, blind lawyer Chen Guangcheng remained under strict house arrest after completing a four-year prison term in 2010, having helped victims of forced abortions to file a class-action suit.

**Protection from Political Terror, Unjustified Imprisonment, Exile, or Torture**

Trials in China, which often amount to mere sentencing announcements, are frequently closed to the public. Torture remains widespread, coerced confessions are routinely admitted as evidence, and there is impunity for suspicious deaths in custody. Many suspects—including a large proportion of political and religious prisoners—are detained by bureaucratic fiat in “reeducation through labor” camps.

Legal amendments passed in March 2011 reduced the number of capital crimes to 55, including nonviolent offenses, though in recent years few individuals had been executed for the removed offenses. The number of executions each year is a state secret, but in December 2011 a scholar from the Chinese Academy of Social Sciences estimated that the number had been halved since the Supreme People’s Court was given authority to review all death penalty cases. The San Francisco–based Duihua Foundation consequently put the number of executions in 2011 at 4,000, though that would still be the world’s largest.

Security forces work closely with the CCP at all levels. During 2011, the CCP continued to expand its apparatus for “stability maintenance,” a term that encompasses maintaining law and order, suppressing peaceful dissent, and closely monitoring the populace. In March 2011, the government announced that it would allocate 624 billion yuan ($95 billion) that year for internal security forces, an increase of over 13 percent from 2010. The new total surpassed the country’s military budget for the first time.

**Equal Treatment of Various Segments of the Population**

In the Xinjiang Uighur Autonomous Region, tightened restrictions that followed ethnic clashes in July 2009 remained in place for much of 2011, including round-the-clock street patrols and tighter monitoring of ethnic Uighur residents. Many of those abducted in large-scale “disappearances” in 2009 remained unaccounted for, and in January 2011 a court official revealed that 376 related trials for “endangering state security” were held in 2010.

**Freedom of Travel or Choice of**

A hukou (household registration) system remains in place, mostly affecting China’s 150 million internal migrants. Some local
| Residence | governments have experimented with reforms, but citizens continue to face restrictions on changing employer or residence, and many migrants are unable to fully access social services, such as education for their children. Among other restrictions on freedom of movement, dissidents, human rights defenders, and certain scholars are prevented from traveling abroad or placed under house arrest. |
| Right to Own Property | Property-rights protection remains weak in practice, and all land is formally owned by the state. Tens of thousands of forced evictions and illegal land confiscations occurred in 2011. Residents who resist eviction, seek legal redress, or organize protests often face violence at the hands of local police or hired thugs. |
| Social Freedom | Despite increasing discussion of potential reforms, China’s population controls remain in place. In urban areas, only one child per couple is permitted, while many rural families are limited to two children. Compulsory abortion and sterilization, though less common than in the past, still occur fairly frequently. According to the Congressional-Executive Commission on China, regulations in 18 of 31 provincial-level administrative units explicitly endorse mandatory abortions as an enforcement tool. Officials who fail to meet birth and sterilization quotas risk disciplinary action, and relatives of unsterilized women or couples with unapproved pregnancies were subjected to high fines, job dismissal, and detention in 2011. |
| Equality of Opportunity | Domestic violence affects one-quarter of Chinese women, according to statistics published in October 2011 by the CCP-controlled All-China Women’s Federation. That month, the group submitted a draft for a national law that would identify domestic violence as a crime; it is currently addressed inadequately via scattered provisions in other laws. Several laws bar gender discrimination in the workplace, and gender equality has reportedly improved over the past decade, but a March 2011 survey by the New York–based Center for Work-Life Policy found that 48 percent of female respondents had scaled back their career ambitions or considered quitting their jobs because of perceived discrimination. |


Besides political rights and civil liberties, the Freedom House produce reports that independently assess the freedom of the press and freedom on the internet among nations. Freedom of the press is the freedom of communication and expression through the use of various mediums, such as electronic media and printed materials, while freedom on the internet is the freedom from control or suppression of publishing or accessing.
information on the internet. Both freedom of the press and freedom on the internet are part of individuals’ civil liberties.

The FOTP report measures the freedom of the press among countries and rates these countries according to the freedom of the press in legal environments, political environments, and economic environments. The criteria used in this report is based on the Yet Article 19 of the Universal Declaration of Human Rights, which states that “Everyone has the right to freedom of opinion and expression; this right includes freedom to hold opinions without interference and to seek, receive, and impart information and ideas through any media regardless of frontiers.” (FOTP, 2012) Based on this principle, countries are scored from 0 (most free) to 100 (least free) from a set of 23 methodology questions. A score of 0 to 30 represents “Free” media; a score of 31 to 60 presents “Partly Free” media; and a score of 61 to 100 represents “Not Free” media.

The FOTP 2012 report on China is unavailable at this point; instead, the FOTP 2011 report on China is used to gauge China’s current condition of press. Based on the 23 methodology questions, the FOTP 2011 report scores China’s freedom of the press 29 points in its legal environment, 34 points in its political environment, and 22 points in its economic environment. By combining these individual scores, China’s overall freedom of the press score is 85 and is ranked 184th place among the 196 countries, which means that China’s media is one of the least free among countries. A description of China’s current key conditions in the freedom of press is presented in Table 4.
<table>
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<tr>
<th>Legal Environment</th>
<th>There is no press law that governs the protection of journalists or punishment of those who attack them. Instead, vague provisions in the criminal code and state-secrets legislation are routinely used to imprison journalists and other citizens for the peaceful expression of views that the CCP considers objectionable. In April, the state-secrets law was revised. But instead of narrowing the definition of what is off-limits, the law extended responsibility to internet and telecom firms to monitor “secret” content. Journalists and their sources remained at risk. The CCP maintains direct control over news media coverage through its Central Propaganda Department (CPD). This is reinforced by an elaborate system of vaguely worded regulations and laws. Taboo topics include calls for greater autonomy in Tibet and Xinjiang, relations with Taiwan, the Falun Gong spiritual group, and any criticism of CCP leaders. In addition, the CPD and provincial censors issue secret directives restricting coverage of breaking news as well as broad areas of content. Reporting on the WikiLeaks disclosures was forbidden, according to international news reports, and the site itself was blocked.</th>
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<tr>
<td>Political Environment</td>
<td>CCP leaders use control of the media to propagate positive views of the party and government, while vilifying those deemed to be their enemies. During 2010, the authorities also continued to employ more subtle means to “guide” news coverage. This included proactively setting the agenda by allowing key state-run outlets to cover ostensibly negative news in a timely but selective manner, then requiring that other media and internet portals restrict their reporting to the established narrative. Those who cross the party-determined lines can also face arrest. According to international media freedom watchdogs, at least 30 journalists were in prison at the end of 2010. The estimate is likely to be low, given the difficulty of collecting accurate information. Several of the year’s imprisonments highlighted the sensitivity of writing about protests against Han Chinese rule in Xinjiang and Tibet. Those imprisoned included Gheyret Niyaz, a former newspaper journalist and the administrator of a website called Uighur Online. He was sentenced to 15 years in prison in July on charges that he endangered state security.</td>
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<tr>
<td>Economic Environment</td>
<td>Media outlets are abundant in China, but the reforms of recent decades have allowed the commercialization of outlets without the privatization of ownership. Most cities have their own newspaper published by the local government or party branch, as well as more commercialized subsidiaries whose revenue comes from advertisements rather than government subsidies. Some observers argue that the commercialization of the market has shifted the media’s loyalty from</td>
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the party to the consumer, leading to tabloid-style and sometimes more daring reporting.


With the continued advance of technology, we are now living in the information age, where information is driven digitally through the worldwide web. The use of the worldwide web significantly increased the speed and range of information dissemination, which connects people around the world through personal computer terminals. China has the world’s largest population of internet users, and their internet user base has reached 538 million at the end of June, 2012 according to CNNIC. (Kan, 2012) As a result of China’s large internet user base, the CPC spent huge amount of resources on the censorship of the internet.

The FOTN report is produced by Freedom House, which measures the freedom of the internet and digit media, particularly mobile phones and text messaging, among countries. The FOTN report rates these countries according to their level of internet and digital media censorship in terms of obstacles to access, limits on content, and violations of user rights. Using a set of 21 methodology questions, countries are scored from 0 (most free) to 100 (least free). A score of 0 to 30 represents “Free” media; a score of 31 to 60 presents “Partly Free” media; and a score of 61 to 100 represents “Not Free” media.

Based on the 21 methodology questions, the FOTN 2012 report scores China’s freedom of the internet and digital media 18 points in term of obstacle to access, 29 points in term of limits on content, and 38 points in term of violations of user rights. By combining these individual scores, China’s overall score in the freedom of the internet
and digital media score is 85 points, which is considered not free. More importantly, China’s FOTN score in the year 2011 was 83 points, two points lower than this year’s score, which means that the CPC took a more repressive stand toward the censorship of the internet and digital media over the past year. A description of China’s current key conditions in the freedom of the internet and digital media is presented in Table 5.

| Obstacles to Access | While the role and presence of information and communication technologies (ICTs) has continued to grow, users still face key obstacles to full and free access. These include centralized control over international gateways, a notable urban-rural gap, and sporadic, localized shutdowns of internet access at sites of protest. The Chinese government has been known to shut down access to entire communications systems in response to specific events. The most dramatic such incident occurred in Xinjiang after an outburst of ethnic violence in the region’s capital Urumqi; the blackout lasted from July 2009 to May 2010. Since then, the authorities have similarly shut down internet communications at sites of unrest though on a smaller scale and lasting for shorter periods of time (usually several days or weeks): in December 2011, around the village of Wukan in Guangdong, after residents revolted against local officials over illegal land grabs; and in February 2012 in Tibetan areas of Sichuan, after clashes surrounding a series self-immolations and reports that soldiers had opened fire on civilians. In a partial shut down, beginning May 30, 2011, nearly all Mongolian chat rooms, discussion forums, blogs and instant messaging platforms, as well as many text-messaging services, were shut down for about a month in Inner Mongolia surrounding protests that erupted after a Mongolian herder was killed. The authorities have sought to exercise increasingly tight control over the cybercafe business and other public access points. The issuance of cybercafe licenses is managed by the Ministry of Culture and its local departments, although to obtain a license, a proprietor typically must also communicate with various other state entities. In January 2011, the Vice Minister of Culture announced that all sole-proprietor cybercafes would be replaced by chains within the next five years, a move that observers believed was aimed at increasing the efficiency of surveillance and censorship. By December 2011, 40 percent of cybercafes in China were reportedly be owned by chains. |
| Limits on Content | The Chinese authorities continue to employ the most elaborate system |
for internet content control in the world. Government agencies and private companies together employ hundreds of thousands of people to monitor, censor, and manipulate online content. In recent years, additional layers have been added to this apparatus, particularly as the CCP seeks to restrict the use of social-networking and microblogging applications for political mobilization and sharing of uncensored information. Even this heavily censored and manipulated online environment, however, provides more space for average citizens to express themselves and air their grievances against the state than any other medium in China.

The CCP’s content-control strategy consists of three primary techniques: automated technical filtering, forced self-censorship by service providers, and proactive manipulation. These techniques mutually reinforce each other to create a highly manipulated information landscape and one notably isolated from international news flows. The purported goal is to limit the spread of pornography, gambling, rumors, and other harmful practices, but web content related to sensitive political or social topics is targeted at least as forcefully. The most systematically censored topics include criticism of top leaders, independent evaluations of China’s rights record, violations of minority rights in Tibet and Xinjiang, the Falun Gong spiritual group, the 1989 Beijing massacre, and various dissident initiatives that challenge the regime on a systemic level.

The first layer of the censorship apparatus is the blocking of access to foreign websites via technical filtering or what is commonly referred to as the “Great Firewall.” In some cases, whole websites are blocked based on their domain name. More common, however, is the authorities’ use of deep-packet inspection technologies to enable filtering of particular pages within otherwise approved sites if the pages are found to contain blacklisted keywords in the URL path. In practice, one of the most important uses the government has made of technical filtering has been to impose blanket blocks on certain Web 2.0 applications, thereby isolating the Chinese public from an international network of user-generated content. Since 2009, the video-sharing platform YouTube, the social-networking site Facebook, and Twitter have remained blocked most of the time in China.

Two companies’ required compliance with government censorship orders is especially notable because of their market dominance and the consequent impact of their actions on the online information landscape as a whole—Sina, which operates Sina Weibo, the most popular microblogging service, and Baidu, which operates the most used search engine. As of February 2012, Sina Weibo reportedly had 300 million users (of which 27 million were active daily), an exponential increase since its launch in 2009. According to Sina executives, the firm has a “very powerful content censorship” system in place, which includes both automated and human monitoring 24 hours a day, run by hundreds of employees. Baidu, which accounts for nearly 80 percent of China’s search engine market, has long been known to manipulate the results it
offers based on government instructions, not only removing certain content, but also favoring state-approved information over content from non-governmental sources or content providers based outside of China.

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<th>Violations of User Rights</th>
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<tr>
<td>Article 35 of the Chinese constitution guarantees freedoms of speech, assembly, association, and publication, but such rights are subordinated to the CCP’s status as the ruling power. In addition, the constitution cannot, in most cases, be invoked in courts as a legal basis for asserting rights. The judiciary is not independent and closely follows party directives, particularly in politically sensitive freedom of expression cases. A wide variety of regulations have been issued by different government agencies to establish censorship guidelines. The National People’s Congress in April 2010 adopted an amendment to the State Secrets Law that requires telecom operators and ISPs to cooperate with authorities on investigations involving the leaking of state secrets. The law took effect on October 1 and has been generally met with compliance from companies, mostly because the economic stakes of disobedience and loss of business license are so high. Vague provisions in the criminal code and state-secrets legislation have been used to imprison citizens for their online activities, including publication of articles criticizing the government or exposing human rights abuses, transmission of objectionable email messages, and downloading of censored material from overseas websites. Prison sentences for online violations tend to be longer in China than in many other countries, often a minimum of three years and sometimes as long as life imprisonment, while punishments elsewhere typically range from six months to four years. Some users are also sentenced without trial to “reeducation through labor” camps for up to three years. Once in custody, detainees frequently suffer abuse, including torture and denial of medical attention. The year 2011 was notable, in particular, for a spate of extralegal abductions and long prison terms imposed in connection with online calls for a Jasmine revolution in China. The calls, which were first posted on the U.S.-based website Boxun and then spread over Twitter, sparked no serious protests, in part because of the strong show of security forces sent to the allotted sites. Some observers noted, therefore, that the authorities may have used the calls as a pretext for a crackdown that had been brewing for some time as CCP officials grew wary of the growing influence of certain activists and their outspokenness online. Beginning in February 2011, dozens of lawyers, activists, and bloggers who had been active both on domestic and international social media were abducted one after another in what became one of the worst crackdowns on free expression in China in recent memory.</td>
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4. Political Economy Analysis of the 18th Politburo Standing Committee

Based on the economic and political freedom indexes, leadership in the past ten years under Hu Jintao has made little effort in reforming China’s economic and political institutions. China’s marginal improvement in economic freedom in the past ten years is undermined by increased level of corruption, government spending, and business regulations. (IEF, 2012) Political freedom in the past ten years, on the other hand, took an obvious backward step, which is evident in the CPC’s increased effort in restricting public discussion of political, legal, and human rights issues, particularly through internet censorship. (FIW, 2012)

China Real Time of The Wall Street Journal did an extensive real-time charted analysis of different aspects of China’s economic development in the past ten years under Hu. This analysis comes down to two conclusions. On the surface, China experienced strong economic growth with a high level of employment, while the CPC continues to secure its political dominance. Beneath the surface, however, China’s economic growth is unlikely to be sustainable as a result of “exhausted exports and real estate sectors, private entrepreneurs choked out of the market, burgeoning inequality and corruption, and fears that reform by Mr. Hu and his team has been insufficient to underpin another decade of growth.” (Orlik, Kim, Lin, and Geng, 2012) This report confirmed China’s economic and political freedom trend measured by the various indexes used above. From these different sources, we can conclude that Hu Jintao did very little during his past two terms in reforming China.

As a result of Hu’s lack of effort in reforming China in his last two terms and the current global economic downturn, China’s economy is facing a slowdown. Therefore,
economic and political institutional reforms are essential in maintaining China’s sustained economic growth. Will the new leadership headed by Xi Jinping and Li Keqiang be willing to push economic and political reforms? The answer to this question largely depends on the composition of the 18th PSC. Therefore, it is imperative to thoroughly analyze the background of each of the seven PSC members in determining the likelihood of economic and political reforms in the next ten years.

To determine the economic and political impact of the seven PSC members, it is essential to break them down to see their factional association. Before analyzing the seven PSC members and their factional association, Table 6 shows the names of the seven PSC members and their positions in the Party and the state, and provides a general idea of who they are in China’s political system.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Current Members</th>
<th>Party Positions</th>
<th>State Positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Xi Jinping</td>
<td>General Secretary of the CPC Central Committee Chairman of the CPC Central Military Commission</td>
<td>Vice President of the People's Republic of China Vice Chairman of the PRC Central Military Commission</td>
</tr>
<tr>
<td>2</td>
<td>Li Keqiang</td>
<td>Deputy Party secretary of the State Council of the People’s Republic of China</td>
<td>First-ranked Vice Premier of the State Council of the People’s Republic of China</td>
</tr>
<tr>
<td>3</td>
<td>Zhang Dejiang</td>
<td>To Be Determined</td>
<td>Third-ranked Vice Premier of the People’s Republic of China</td>
</tr>
<tr>
<td>4</td>
<td>Yu Zhangsheng</td>
<td>To Be Determined</td>
<td>To Be Determined</td>
</tr>
<tr>
<td>5</td>
<td>Liu Yunshan</td>
<td>Top-ranked Secretary of the Central Secretariat of the CPC</td>
<td>To Be Determined</td>
</tr>
<tr>
<td>6</td>
<td>Wang Qishan</td>
<td>Secretary of the Central Commission for Discipline Inspection</td>
<td>Fourth-ranked Vice Premier of the People’s Republic of China</td>
</tr>
</tbody>
</table>
Among the seven PSC members, their diverse political background not only determines how they would function as a team, but it also determines the nature of factional competition among themselves, because each of them represents different kinds of economic and political interests. Therefore, it is important to become familiar with the political background of each of the seven PSC members.

Xi Jinping, the 1st-ranking PSC member, rose to the top of the political ladder as a princeling politician through the connection of his father, Xi Zhongxun, a communist veteran under Deng Xiaoping. He is also a protégé of Jiang Zemin. Xi studied chemical engineering at the prestigious Tsinghua University, and then later obtained his doctorate in Marxist theory and ideological education.

As a princeling politician, Xi served as the secretary general of Zhengding County of Hebei in 1982, and was promoted to Deputy Governor of Fujian province in 1999. As Governor, Xi facilitated free market economic development and attracted major investments from Taiwan. Two years later, Xi was transferred from Fujian to the neighboring province of Zhejiang in 2002, and served as the Governor and party chief. During his time in the economically developed Zhejiang, Xi contributed to Zhejiang’s averaging growth rate of 14 percent, and was popular for his tough approach to corruption. In 2006, Xi replaced Shanghai’s Party Chief Chen Liangyu after Chen’s scandal. The party chief position in Shanghai opened the opportunity for Xi to move to
the top of China’s political pyramid. In October 2007, Xi was included in the 17th PSC, and then in March 2008, Xi was elected as the Vice-President of the People’s Republic of China before replacing Hu Jintao as China’s next generation leader.

As the head of the fast-growing provinces of Fujian, Zhejiang, and Shanghai, some analysts believe that Xi has a market-friendly approach to economic development, which means that he is likely to support private sector growth, foreign investment, and trade. However, he has also shown support for strengthening the state-owned enterprises. In addition, with his doctorate degree in Marxist theory, Xi is believed to be conservative toward political reforms. (Kuo, 2012)

Li Keqiang, the 2nd-ranking PSC member, rose to the top of the political ladder through the Communist Youth League (CYL). Unlike Xi, Li’s father was a local official in Anhui province, so his family had no strong political connection. Li was sent for rural labor during the Cultural Revolution in Anhui, where he joined the CPC and eventually became the party head of the local production team. Li obtained an LLB from the School of Law and a PhD in economics at the prestigious Peking University. He also translated the British judge Lord Denning’s book “Due Process of Law.” His academic experience is a sign of his openness to political and legal reforms. (Kuo, 2012)

In 1980, Li became the Secretary of CYL at Peking University, and then entered the top leadership of the CYL in 1982. At the time, he worked closely with Hu Jintao. In 1993, Li became the organization’s General Secretary. In June 1998, Li was appointed as the Governor of Henan province. As the governor, Li focused on transforming the poor inland region into an attractive area for investment, and contributed to Henan’s rapid
GDP growth from 28th place from the provinces in early 1990s to 18th place in 2004. During his appointment, Li refused to participate in banquets and fancy events not associated with his work. (Duowei News, 2007)

In December 2004, Li was transferred to work as the Party Chief of Liaoning province. As the party chief, Li established the “Five-points to one line” project, which increased the trade flow by linking up the seaport cities of Dalian, Dandong, and a series of other ports. In October 2007, Li was included in the 17th PSC, and in March 2008, he was elected as the first ranked Vice-Premier.

Zhang Dejiang, the 3rd-ranking PSC member, rose to the top of the political ladder as a princeling politician. Zhang is the son of Zhang Zhiyi, a former major general of the People’s Liberation Army, and is considered a protégé of Jiang Zemin. (Rovnick, 2012) Zhang obtained a degree in economics in 1980 from Kim II-sung University in North Korea. Zhang was a local official in Yanbian, Jilin province, where he was recognized for handling the issue of illegal immigration from North Korea. In March 1990, Zhang came to know Jiang by accompanying Jiang on a visit to North Korea. Soon after the trip, Jiang promoted Zhang to Deputy Party Secretary of Jilin province. Then in 1998, Zhang was transferred to Zhejiang province as the Party Secretary.

In November 2002, Zhang was transferred to Guangdong province as the Party Chief. During his appointment in Guangdong, Zhang worked on the Pan-Pearl Delta economic integration to increase the interdependence among Hong Kong, Macau, Guangdong, Fujian, Jiangxi among others. (Ying, 2004) However, critics claim that Zhang’s motive in promoting the policy was for his future promotions. A senior journalist
compared Zhang with Bo Xilai, saying that “Bo Xilai manipulates the media to promote himself, while Zhang Dejiang manipulates the media to promote his grandiose plans.” (Ying, 2003)

Zhang was also accused of suppressing the media and the right to protest. While serving in Guangdong, Zhang was blamed for restricting the flow of information to the public during the time of the SARS outbreak, and shuttering the Southern Daily newspaper and 21st Century World Herald newspaper. Zhang was also blamed for the police shooting of villagers for protesting against inadequate compensation for seized land in 2005, which caused the death of 20 villagers. (Ying, 2003)

In 2008, Zhang was appointed Vice-Premier, overseeing China’s energy, telecommunications, and transportation industries. In March 2012, Zhang was appointed the Party Chief of Chongqing following the dismissal of Bo Xilai. Based on Zhang’s record in Guangdong, it is widely believed that Zhang’s rise is the result of his close connection with Jiang Zemin. (Lau, 2012)

Yu Zhengsheng, the 4th-ranking PSC member, rose to the top of the political ladder as a princeling politician. Yu’s grandfather’s brother served as Defense Minister under Chiang Kai-shek, and his father Yu Qiwei was the ex-husband of Jiang Qing and served as Party Secretary and Mayor of Tianjin province in the early 1950s. (Brookings, 2012) Yu was also a friend of Deng Xiaoping and the son-in-law of PLA’s Major General Zhang Zhenhua. Yu served as the proxy or representative in politics for Deng Xiaoping’s family. (Lim, 2007) Yu married Zhang Zhikai, the daughter of PLA’s Major
General Zhang Zhenhua. Yu also formed a strong tie with Jiang Zemin at the Ministry of Electronics Industry in the early 1980s. (Brookings, 2012)

In his earlier political career, Yu served as the mayor of Qingdao and Yantai of Shandong province, and then became the Party Chief of Qingdao. In 1997, Yu served as Deputy Minister of Construction, and then was promoted into the Minister position a year later. Yu was a member of Zhu Rongji’s cabinet from 1998 to 2001. After the 17th Party Congress, Yu replaced Xi Jinping as Party Chief of Shanghai.

Liu Yunshan, the 5th-ranking PSC member, rose to the top of the political ladder through the Communist Youth League (CYL). Liu formed a close tie with Hu Jintao when they worked together at the CYL. From 1968 to 1993, Liu worked as a clerk in the Propaganda Department of the CPC Committee of the Tumd Right Banner of Inner Mongolia AR, a reporter of the Mongolia AR branch of the Xinhua News Agency, and Deputy Head and Head of the Propaganda Department of the CPC Committee of Inner Mongolia AR. Liu was later promoted to Secretary General of the CPC Committee of Inner Mongolia AR, Party Secretary of Chifeng City, and Deputy Party Secretary of Inner Mongolia AR. From 1993 to 2002, Liu was transferred from Inner Mongolia to Beijing, where he was appointed as Deputy Director of the CPC Propaganda Department. (Brookings Institution, 2012)

Liu is currently the Director of the CPC Propaganda Department. As the head of the CPC Propaganda Department, Liu oversees the country’s censorship system, and helped create China’s Great Firewall, the world’s largest internet-blocking campaign. At
the time of the high-speed train crash in Wenzhou province in July 2011, which killed 40
and injured 172, Liu blocked media outlets from reporting this accident. (Kuo, 2012)

Wang Qishan, the 6th-ranking PSC member, rose to the top of the political ladder
as a princeling politician. Wang is the son-in-law of Yao Yilin, a former PSC member
and Vice-Premier, and he is also a protégé of Jiang Zemin and Zhu Rongji. From 1979 to
1982, Wang worked as a researcher and director at the Institute of Contemporary History
of the Chinese Academy of Social Sciences. From 1982 to 1988, he worked in the Rural
Policy Research Office of the CPC Central Committee. Wang served as General Manager
of the Agriculture Credit and Investment Company from 1988 to 1989, Vice-Governor of
China Construction Bank from 1989 to 1993, Vice-Governor of the People’s Bank of
From 1997 to 2004, he served as the Party Secretary and Mayor of Hainan, and then
Wang served as the Mayor of Beijing from 2004 to 2007. Wang became the Vice Premier

As a protégé of both Jiang Zemin and Zhu Rongji, Wang is in charge of economic
and financial affairs, and his policies are known for reforming China’s tax system,
liberalizing China’s financial system, and encouraging foreign investment and trade. As a
result of his reform oriented policies, Wang is perceived as the economic reformer-in-
waiting. Wang is also known as a decisive problem solver. After Wang was appointed the
mayor of Beijing, he helped contain the SARS virus at the height of the SARS outbreak
in China. (Kuo, 2012)
Zhang Gaoli, the 7th-ranking PSC member, rose to the top of the political ladder as a protégé of Jiang Zemin and Zeng Qinghong. Zhang received his education from Xiamen University and is an economist by profession. As an economist by training, Zhang has pushed for greater foreign investment in China. Zhang has kept a low political profile, and was quoted as saying “Do more. Speak less.” (Kuo, 2012)

From 1997 to 2002, Zhang held a leadership position in the provincial government of Guangdong, and contributed to the rapid development in the special economic zone of Shenzhen. With his economic mind, he was appointed the first-in-charge of CPC Shandong Committee Secretary, overlooking the economic development of Shandong province. (Brookings Institution, 2012)

Based on the political background of the seven PSC members, four PSC members, Xi Jinping, Zhang Dejiang, Yu Zhengsheng, Wang Qishan, belong to the princeling faction, while two PSC members, Li Keqiang and Liu Yunshan, belong to the populist faction because they came to power through the CYL. Zhang Gaoli is the only person who is not a princeling and did not came to power through the CYL; but as a protégé of Jiang Zemin, he is considered a member of the Shanghai clique. Among the four princelings, all are protégés of Jiang Zemin, which means these princelings are also associated with the Shanghai clique.

The four princelings combined with Zhang Gaoli forms the elitist faction (princeling faction and Shanghai clique), which outnumbers the populist faction in the ratio of 5 to 2. This unbalanced factional composition signals the overall conservative nature of the 18th PSC as a whole. The current PSC dominated by the elitist faction
implies that the rich are likely to become richer while the poor are likely to become poorer, which would widen the gap of China’s income inequality.

Even without considering Zhang Gaoli, the populated princelings ensure the conservative nature of the current PSC. Princelings come to power through the political connections of their parents. Therefore, they are the beneficiaries of China’s highly connected political system, and, through “guanxi” or connections, have achieved high political status and have accumulated huge amounts of wealth with relative ease. After they came to power, they protect this system in order to continue to extract political and economic benefits for themselves and their children. Even with reform minded PSC members of Li Keqiang and Wang Qishan, it would be hard for them to implement major political and economic reforms due to the overwhelming conservative force in the current PSC.

Besides factional composition of the 18th PSC, the likelihood of the new leadership in pursuing the conservative path is also reinforced by the nature of the selection process of the 18th PSC members. According to political insiders and analysts, the new PSC is shaped more so by the powerful interest groups behind the scene, particularly a group headed by its 86-year-old former chief Jiang Zemin, rather than through transparent political competition. Even though Jiang stepped down as party chief in 2002, he outmaneuvered Hu Jintao in selecting PSC members associated with his elitist faction. (Page, 2012)

In addition, Hu not only stepped down as party chief, he also transferred military command to Xi Jinping. Hu is the first leader in the CPC to give up all his formal powers,
which is another sign that the populist faction lost power in the negotiation during the current transition process. A weakened populist faction in the 18th PSC is unlikely to succeed in pushing major political and economic reforms, which makes the conservative path even more likely.

5. The Impact of Corruption on China’s Future Reforms

On top of factional competition within the Politburo, increased level of corruption over the last decade makes political and economic reforms even more unlikely. During the new leadership transition, one of the central talking points is widespread corruption. As stated by Hu Jintao during the 18th National Congress, "If we fail to handle this issue well, it could prove fatal to the party, and even cause the collapse of the party and the fall of the state. We must thus make unremitting efforts to combat corruption." (Wee and Blanchard, 2012)

Given the severity of corruption in China, combating corruption becomes the top priority of the new leadership under Xi. Xi made similar speeches on corruption after he assumed power. As quoted by Xinhua News, "The large number of facts tells us that if the problem of corruption becomes increasingly severe, it will lead to the ruin of the party and the country!" (CBSNews, 2012) Even though Xi did not mention any specific mechanisms for how the new leadership would combat corruption, he did send a clear warning: “All behavior that violates party discipline or the law should be punished without mercy,” which signaled the new leadership’s determination in combating corruption. (Ford, 2012)
Over the past five years, approximately 668,000 CPC members have been punished for corruption, and according to experts, this figure is tiny compared to unreported corruption. (Ford, 2012) In recent years, the investigation of high profile corruption of top level leaders came into more exposure, particularly by foreign media and China’s microblogging sites, known as Weibo.

The tremendous wealth accumulated by China’s top officials through corruption was exposed by reporters at the Financial Times titled “The Family Fortunes of Beijing’s New Few.” (Financial Times, 2012) Through powerful political family connections, top officials were made “fabulously wealthy while ignoring the rules of laws they set for the rest of society.”

The significant increase in the wealth of top leading officials in Beijing in the past decade was exposed in an article written by reporters at the Financial Times under the title “The Family Fortunes of Beijing’s New Few.” (Financial Times, 2012) According to the article, the nation’s wealth is concentrated in the hands of a few powerful political families, and they are made “fabulously wealthy while ignoring the rules of laws they set for the rest of society.” The article also quoted a remark made by Professor Andrew Nathan of Columbia University, co-editor of The Tiananmen Papers, a collection of top-level decision-making documents of the Tiananmen Square student protests leaked out of China. “Powerful political families have come to control vast swaths of the Chinese economy in an environment where there is no separation of powers, no independent judiciary or media and the government sits astride everything,” (Financial Times, 2012)
On a follow up article by the reporters of the Financial Times titled “China’s Powerful Families,” major business interests held by the immediate family of China’s current and retired members of the PSC were exposed. This changing behavior of politicians set a direct contrast to the time under the leadership of Jiang Zemin and Zhu Rongji. “In the 1990s most senior leaders at least tried to moderate their princelings as they got rich but now there is almost no restraint and it has gotten out of control,” says a leading Chinese financier with close ties to the party leadership. (Financial Times, 2012)

Even premier Wen Jiabao, also known as the “People’s Premier,” who has earned himself a considerable reputation as an approachable leader in touch with commoners, was recently exposed by The New York Times for his net wealth of at least $2.7 billion. According to The New York Times, many relatives of Wen have become extraordinarily wealthy during this leadership as premier, including his mother, wife, son, daughter, younger brother, and brother-in-law. In many cases, the names of the relatives are hidden behind many layers of business dealings. Through digging into corporate and regulatory records, The New York Times found that Wen’s relatives have controlled at least $2.7 billion worth of assets. (Barboza, 2012)

According to corporate and regulatory records, Wen’s 90 years old mother, Yang Zhiyun, held one investment valued at $120 million five years ago. Wen’s wife, Zhang Beili, is a businesswoman dealing jewelry and gemstones. By managing state-owned companies, “she helped her relatives parlay their minority stakes into a billion-dollar portfolio of insurance, technology and real estate ventures.” (Barboza, 2012) Wen’s son manages New Horizon Capital, now one of China’s biggest private equity firms. His son
previously sold a technology company to Hong Kong’s richest man, Li Ka-shing, for $10 million. The premier’s younger brother, Wen Jiahong, runs wastewater treatment plants and recycling businesses, which controls $200 million in assets. (Barboza, 2012)

The Bloomberg News recently exposed the business stakes held by the extended family of Xi Jinping, the fifth generation leader and head of the princeling faction. Xi’s business interests include “investments in companies with total assets of $376 million; an 18 percent indirect stake in a rare-earths company with $1.73 billion in assets; and a $20.2 million holding in a publicly traded technology company. The figures don’t account for liabilities and thus don’t reflect the family’s net worth.” (Bloomberg News, 2012) All of these assets are traced to Xi’s older sister Qi Qiaoqiao and her husband Deng Jiagui.

During the 18th National Congress, Hu Jintao promised “reforms to the political structure” but is unwilling to pursue path of a Western political system. (Wee and Blanchard, 2012) Hu stated that "Combating corruption and promoting political integrity, which is a major political issue of great concern to the people, is a clear-cut and long-term political commitment of the party." Hu also stated that "All those who violate party discipline and state laws, whoever they are and whatever power or official positions they have, must be brought to justice without mercy." (Wee and Blanchard, 2012)

From Hu Jintao’s and Xi Jinping’s speeches, it is certain that the new leadership views combating corruption as one of their top priorities. However, in a country where “gift-giving is a pillar of traditional culture, a single political party has a stranglehold on power, and bribery is pervasive from top to bottom of society,” (Ford, 2012) if top
leaders cannot constrain their own actions in taking bribes, it is hard to imagine that they can constrain corruption at levels below them, such as provincial officials, local officials, officials of the state-owned enterprises, etc.

Therefore, the biggest question mark here is whether the top leaders are willing to constrain their own corruptive actions? The obvious answer to this question is no based on the composition of the new leadership and the nature of its selection process. First, with princelings dominating the 18th PSC, their top priority is to preserve the current system of “guanxi” or strong political ties. Through mobilizing and expanding “guanxi,” it allows them to provide additional political interests to their constituents, and in return, they can extract additional economic interests. Therefore, the new leadership dominated by princelings can only make corruption worse over time.

Second, the nature of the 18th PSC’s selection process shows that the new leadership does not have independent control over future political and economic reforms. The selection process of the 18th PSC demonstrated that the negotiation between elderly party members is what really determined the composition of the 18th PSC. Through negotiations by the elderly leaders of different factions, particularly between Jiang Zemin and Hu Jintao, Jiang outmaneuvered Hu, which resulted in the princelings dominating the 18th PSC. As pointed out by economist Charles Rowley, General Director of The Locke Institute, Jiang as the determining factor to the composition of the 18th PSC “signals a victory for those who favor the status quo over those who press for political and economic reform.” (Charles Rowley’s Blog, 2012)
Economist Rowley also pointed out that the exclusion of the two strongest figures in favor of political reform, Li Yuanchao, the head of the CPC’s organization department, and Wang Yang, Guangdong party chief, further signaled the CPC’s resolve for status quo. (Charles Rowley’s Blog, 2012) With elderly party members maneuvering behind-the-scenes, they would continue to resist reforms, which makes the recent talk of combating corruption very unlikely.

To resolve this fundamental problem of corruption, John Foley, Reuters Breakingviews columnist, suggested two methods of combating corruption. One method is to increase the likelihood of officials getting caught for illegal acts. At the central level, the Disciplinary Commission of the CPC must take tougher actions in punishing corrupted officials. Another method is to have greater press freedom for exposing misdeeds. (Foley, 2012) However, a highly corrupted top leadership dominated by princelings and controlled by elderly party members behind-the-scenes makes these two methods unlikely to be effective.

An alternative to combating corruption is the implementation of “sunshine law.” Corruption watchers agreed that the first step in combating corruption is to establish some kind of “sunshine law,” in which officials are obligated to declare their income and assets. The effectiveness of “sunshine law” is dependent on the credibility of declarations. (Ford, 2012) Therefore, declarations of income and assets must be verified by a third party organization that is independent of the Party’s control.
6. Conclusion

Using widely accepted indexes on economic and political freedom calculated by various non-governmental organizations, the trend of economic and political freedom in China under Hu Jintao in the past decade has been assessed. Given China’s rapid economic growth and accession to the WTO, China’s economic freedom ranking increased in some areas but decreased in other areas, but the rapid growth has had little impact on China’s progress toward being a more politically free state. If anything, China’s rapid economic growth has negatively impacted China’s progress toward being a more politically free state.

China’s future economic and political freedom in the next decade, however, is largely dependent on the composition of the 18th PSC headed by Xi Jinping. With the 18th PSC dominated by princelings, the new leadership is very likely to pursue a conservative path in order to protect and to continue the extraction of political and economic benefits, both for themselves and their children. The overwhelming conservative force in the current PSC also creates resistance to reform minded PSC members of Li Keqiang and Wang Qishan.

Rampant corruption in China is another fundamental problem that must be resolved in order to improve the economic and political freedom in China. To resolve this fundamental problem of corruption, John Foley, Reuters Breakingviews columnist, suggests two methods of combating corruption. One method is to increase the likelihood of officials getting caught for illegal acts; and the other method is to give greater freedom to the press in China in order to expose misdeeds more effectively. (Foley, 2012)
However, the current PSC, dominated by the highly corrupted princelings, is unlikely to reduce the level of corruption in China. Therefore, an alternative method to combating corruption in China is “sunshine law,” whose effectiveness is largely dependent on the credibility of declarations (Ford, 2012)
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CURRICULUM VITAE

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