



MPIfG Discussion Paper 11/2

**Institutional Change in Market-Liberal State Capitalism**

An Integrative Perspective on the Development  
of the Private Business Sector in China

Tobias ten Brink



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MPIfG Discussion Paper 11/2

Max-Planck-Institut für Gesellschaftsforschung, Köln

Max Planck Institute for the Study of Societies, Cologne

March 2011

MPIfG Discussion Paper

ISSN 0944-2073 (Print)

ISSN 1864-4325 (Internet)

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## Abstract

This paper shows that a more accurate depiction of the development of China's private sector is gained by considering the complex interaction between bottom-up and top-down processes. First, the paper analyzes the general characteristics of Chinese capitalism to help understand and classify the gradual institutional change in the enterprise sector. Second, it draws on insights from comparative political economy and new approaches in political science to introduce the strategy of "wearing a red hat," an empirical phenomenon that provides a framework for the emergence from the 1980s of China's private sector. This section also examines the closely interwoven relationships between private companies and the party-state that have taken place since the 1990s. Third, the paper indicates that focusing on state/capital relationships at different administrative levels contributes to a better understanding of China's private sector. It concludes that the development and success of the new private enterprises, which remained closely linked to the state, enabled the ruling elite to form and consolidate a hegemonic project that provided relative societal coherence on the often bumpy road to reform.

## Zusammenfassung

Dieser Artikel zeigt auf, dass ein Blick auf die komplexen Interaktionen zwischen „Bottom-up“- und „Top-down“-Prozessen ein präziseres Bild der Entwicklung des Privatsektors in China liefert. Dabei hilft erstens eine Analyse von grundlegenden Merkmalen des chinesischen Kapitalismus, um den graduellen institutionellen Wandel im Unternehmenssektor verstehen beziehungsweise einordnen zu können. Unter Bezugnahme auf die Vergleichende Politische Ökonomie und neuere politikwissenschaftliche Ansätze werden, zweitens, die empirischen Phänomene des „wearing a red hat“ in der Entstehungsphase des Privatsektors ab den 1980ern sowie der seitdem eng verknüpften Beziehungen zwischen Privatunternehmen und dem Parteistaat eingeführt. Drittens wird erörtert, dass ein Fokus auf die engen Beziehungen zwischen Staat und Kapital auf verschiedenen administrativen Ebenen zu einem besseren Verständnis des chinesischen Privatsektors beiträgt. Wie abschließend festgehalten wird, ermöglichte die Entwicklung und der Erfolg der neuen privaten, jedoch weiterhin eng mit dem Staat verbundenen Unternehmen es der Machtelite, ein hegemoniales Projekt zu formieren und aufrechtzuerhalten, das dem holprigen Reformweg eine relative gesellschaftliche Stabilität verlieh.

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## Institutional Change in Market-Liberal State Capitalism: An Integrative Perspective on the Development of the Private Business Sector in China

### 1 Introduction

Since the 1980s, an impressive and – by comparison to other countries and regions – flourishing private sector has emerged in China. In a protracted incremental process of informal coping strategies by businessmen, the corporate sector underwent a gradual, yet transformative reorganization. It seems as if now a legitimized private sector prevails where once different forms of state enterprises dominated.

Overall, statistics show a clear increase in companies that are formally run as private businesses: in 1978, SOEs (state-owned and state-controlled enterprises) accounted for 77.6 percent of industrial output. The figures for 2006 suggest a share of industry output by SOEs of 31.2 percent, while the share of private companies has risen to 37.2 percent. The share of foreign-funded private enterprises, including investment from Hong Kong, Macau and Taiwan, amounts to 31.6 percent. At present, the private economy, understood in a very broad sense as comprising “collective,”<sup>1</sup> individual and other private enterprises, thus accounts for 65 percent of GDP (cf. NBS 2009; Chen/Wang 2010: 45–50).<sup>2</sup>

How did this transformation take place? What shaped the evolution of the new private business sector? Will this process lead to a liberal market economy? To answer these questions, I adopt an integrative perspective that focuses on wider institutional environments and social contexts. An accurate analysis of the corporate sector cannot confine itself to the conventional unit of analysis, the firm. As firms both instigate and absorb institutional change, theoretical approaches need to be widened to reflect the importance of business relations in the form of coordination *and* ties with political structures. While there is now widespread acknowledgment that the institutional environment conditions the economic field, many endeavors to identify these institutions neglect the “non-market” relations that may be important as explanatory variables.

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I would like to thank Luo Siqu, Helen Callaghan, Britta Rehder and Guido Moellering for their helpful comments. Furthermore, this paper benefited from comments made at the “Working Group on Institutional Change,” held at the MIT Political Science Department in Cambridge, February 4–5, 2011.

- 1 Collectively owned enterprises (COEs) at the subnational level often represent enterprises owned by cities, urban districts and communities that have been wholly or partially privatized in recent years. As will be seen in the following, formal legal differentiation between company forms in mainland China is difficult. This is due among other things to the peculiar structure of Chinese capitalism, blurred dividing lines between public and private property, and the corresponding spread of inaccurate expressions such as “non-state” or “popularly managed” companies.
- 2 As a matter of fact, different calculations lead to different results. Compare for instance Huang (2008: 13–19), whose figures show that the sum of indigenous and foreign private firms only amounted to 50.8 % of industrial output in 2005.

While it is important to highlight the importance of the practices of entrepreneurs in the creation of new businesses, I believe that such practices go well beyond “managerialist” assumptions in neoclassical economics as well as “voluntaristic” theories in sociology and political science (cf. Powell/DiMaggio 1991).

Three perspectives inform my analysis of the development of China’s private business sector: *First*, I assume that an appreciation of general characteristics of the contemporary Chinese system – perceived as a distinctive form of market-liberal state capitalism – helps us to understand and classify the specificity of gradual institutional change in the enterprise sector. Consequently, the paper rejects the notion that “postsocialist” societies inevitably move towards a liberal market economy. *Second*, I draw on insights from Comparative Political Economy and new approaches in political science for the analysis of gradual institutional change, introducing the empirical phenomena of “wearing a red hat” – a saying that refers to the practice of informal privatization that shaped the emerging private sector from the 1980s onwards – and the closely interwoven relationships between private companies and the party-state since then. *Third*, although the paper focuses on the bottom-up processes of entrepreneurial experimentation, it shows that the state/capital relationships at different administrative levels contribute to a more precise picture of the design of China’s private sector.<sup>3</sup> Thus, this paper shows that private sector flourishing was not just induced by flexible informal institutions from below – by managerial agency creatively dealing with constraints as told in liberal marketization success stories (Huang 2008) – and nor was it just a top-down process led by the party-state (Yang 2004).

I begin by discussing the essential spheres of China’s new capitalism and introduce several tools for understanding gradual institutional change within the private business sector. In the empirical sections, I document the strategy of “wearing a red hat” and the phenomenon of thickly embedded capitalists. To gain a wider view, I then outline several dimensions of enterprise-embedding within China. I then analyze the corporate sector against the background of multi-level governance, state entrepreneurialism, private-public networks, and the capacity of the central state to steer and reform, and I provide additional information on opportunity structures for gradual changes in the trade regime. I conclude that the development and success of the new private enterprises, which remained closely linked to the state, enabled the Chinese ruling elite to form and consolidate a hegemonic project that provided relative societal coherence on the often bumpy road to reform.

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3 By challenging theories of market transition, which argue that the “transition from redistributive to market coordination shifts sources of power and privilege to favor direct producers relative to redistributors” (Nee 1989: 663), this paper does not overlook the numerous possibilities for “redistributive power” to capture market opportunities. This is because the ruling elite controlled resources that were indispensable in the evolution of new markets (cf. Szélenyi/Kostello 1996).

## 2 Competition-driven state capitalism

To avoid reducing significant institutional change to either the achievements of individuals or the shrewdness of entrepreneurs, one has to give due weight to the broader changes in Chinese society that have led to a form of “Chinese capitalism.” To examine the specific features of the corporate sector requires the historical variability of capitalist systems to be taken into account. The need to differentiate between various types of capitalism is rooted in the acknowledgement that there is a spatiotemporal unevenness between the major subsystems of the world economy. The “internationally variegated capitalist world system” (Streeck 2010: 38) is made up of a network of capitalisms, along national and regional lines, that differ but are at the same time linked and which undergo permanent processes of differentiation and adaptation.

I refer here to the findings of Comparative and International Political Economy (cf. Amable 2003; Coates 2000; Jessop/Sum 2006; Streeck 2009, 2010). A critical review of current theories of capitalism (ten Brink 2008: 50–97; ten Brink 2010) enables an analytical framework<sup>4</sup> to be formulated that distinguishes between five structural characteristics of capitalist systems in general, whose mixture-ratios then produce different historical variants of capitalism:

- The horizontal axis of capitalist competition, i.e. the systemic requirement for extended accumulation and innovation for the sake of profit maximization through competition between companies. This generates an unsynchronized, crisis-prone dynamism.
- The vertical axis of capitalist social relations, i.e. the class polarization between those with and those without wealth, the social structural conflict it feeds and the motivations for individual social advancement it creates. This axis, which allows distinct labor systems and intermediary institutions to develop that may or may not be labor-inclusive, opens up different paths to an entrepreneurial “freedom” to act.
- The establishment of monetary zones and specific financial systems which lead to the differentiation of distinctive varieties of capitalism and company strategies.
- The interaction between economic and political actors that form a network characterized by structural interdependencies. Government actions play a constitutive role in shaping economic processes. In reality the crisscross of areas of government responsibility and its underlying institutional characteristics is the basis for distinct political systems – such as liberal states or, in the case of China, the “party-state.” In order to be able to distinguish between political systems, varying degrees and forms

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4 In contrast to transhistorical reasoning, this framework focuses “not on *institutions as such*, and not even on *economic institutions*, but on the *economic institutions of capitalism*” (Streeck 2009: 231) – i.e. on capitalist imperatives which shape the business sector in myriad ways.

of state intervention and business promotion must be taken into account. State intervention and state ownership need not exclude capitalist ownership but can be among the many forms of particularistic control and the exercising of economic and political power, e.g. in the form of state capital.

- The international and transnational embeddedness of capitalist systems, i.e. their specific integration in global economic, (geo-)political and other intersocietal relations.

The specific combination of these five features to be found in the People's Republic of China makes for a distinctive form of capitalism. A market-liberal entrepreneurial spirit coexists with widespread state interventionism, which in turn is guided by macro-economic success parameters manifested in a heterogeneous bundle of private-public economic regimes.<sup>5</sup> The peculiarities of Chinese market-liberal state capitalism, established during the reform era, include:

*First*, special forms of competition and private-public corporate organization. The accumulation drive in China is being achieved in an environment where economic rights of disposition and control shift from state authorities to the management of numerous companies (Nee 2005). This process reconfigures the structurally interdependent relations between economic actors and those with political power. These relationships are generally governed by a “mixed economy” system of formal and informal relations that is neither “free” nor “competitive” in the classic sense. Although a renewed form of state enterprise is dominant at the level of central government, private-public economic regimes have gained particular significance at the subnational level. As shown in the following, the predominant practice of informal privatization (“wearing a red hat”) began to include formal privatization from the 1990s – without overriding the symbiotic ties between party, state and industry.

*Second*, the emergence in urban labor relations of a fragmented type of labor-exclusive corporatism in terms of intermediary institutions. The remodeling of labor relations is generally based on fragmented regulation that is evident from an inadequate implementation of legal norms and a lack of effective institutions to create a balance between labor

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5 The Chinese system can only be equated to a simple hybrid of “capitalist” and “socialist” principles under very narrow definitions of these terms – “socialism” as understood by the current Chinese leadership as pursuing economic growth by any means deemed necessary, and “capitalism” as a mere synonym for markets. A better understanding is to therefore consider China's economic polity as a form of state-led capitalist developmentalism (for a more detailed account, cf. ten Brink 2010). Contrary to “Sinomania”-reasoning by Western commentators, the contradictions of the Chinese “miracle” must also be considered. Immense internal polarization and its opposing dynamics, the coexistence of highly developed and large expanses of backward, agricultural regions, and the related problems of over-investment and under-consumption, make for a highly divided regime of accumulation.



and (state) capital.<sup>6</sup> The various types of production regimes, a massive segmentation and flexibilization of employment, low base wages, long working hours that are often in violation of existing legal standards and also huge wage differentials between employees, and the lack of trade union mobilization capacity opened an expanse of opportunities for (but were also the result of) private entrepreneurial “experiments” that had elements that were innovative as well as destructive.

*Third*, the strategic role of government in regulating financial and monetary relations that prevents simple adaptation of a liberal model (Naughton 2007: 449–481). State banks act as the main financing sources of economic growth, which means that although a number of firms on the fringe strongly rely on informal sources, larger companies depend on these quasi-state entities. In addition to the four largest commercial banks and several central state-controlled “policy banks,” other commercial, mainly listed banks have started to make their presence felt. Most of them flourish on the basis of local power structures. From 2005 on, classic private banks were admitted for the first time. Up to the present day, financing by bank loans is more common than by the capital market. Nevertheless, the capital markets have burgeoned into the second largest in Asia.<sup>7</sup>

*Fourth*, a political system constituted by a notable combination of central and decentralized power. This competition-driven form of multi-level governance, which will be dealt with in more detail in section 5, is a key factor in capturing the dynamics of company reorganization because it brought about relative social stability and thus made possible many of the significant transformations in the first place.

*Fifth*, Chinese integration into global economic, East Asian and other transnational relations and power structures that has led to a fragile but, up to now, mainly dynamic balance of power between mainland Chinese, overseas Chinese and foreign economic engagement. The People’s Republic developed its economy in a phase of advanced transnationalization that coincided with changing global economic and geopolitical structures and contributed to a significant opening up of the economy. The relative success of company reorganization in China is thus partly due to favorable external opportunity structures – China became the world’s most attractive production location at the precise moment when real accumulation in the old centers was slowing down after the 1970s and a new international division of labor was emerging (cf. Brenner 2006; Breslin

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6 When, in the face of group interests from entrepreneurs (and, for example, by the activation of the *All China Federation of Industry and Commerce*, cf. Holbig/Reichenbach 2005), the state occasionally assumes the role of a balancing element. This corresponds to a fundamental state “responsibility” in capitalist societies – and should not be misinterpreted as a relic of “socialism.”

7 The reforms of the financial system highlight another area of institutional layering and conversion which cannot be considered here. But there are also signs of institutional blockade and disorder: For instance, when the new “policy banks” were grafted onto the existing system in the 1990s – with the aim of taking on the tasks performed by the four existing specialized banks – the “Big Four” continued to operate in their old realms and retained responsibility for financing government projects.

2007; Hung 2009). The geopolitical landscape had also changed, i.e. improved relations with the US, that worked in China's favor. Furthermore, the almost global expansion of market relations from the 1970s onwards, accompanied by the belief in dynamic markets, the role of individual entrepreneurialism, new administrative structures and liberal concepts of Corporate Governance greatly encouraged mainland China to create a private sector.<sup>8</sup>

China has undergone an unprecedented transformation from a planned economy to a strongly market-oriented system while exhibiting a degree of continuity in its political and social institutions. The vestiges of a bureaucratic planned economy, a ruling communist party, and late industrial development will be part of the Chinese model for the foreseeable future.<sup>9</sup> Research on China has for some time now focused on this aspect of restructuring that is both path dependent and path shaping (cf. McMillan/Naughton 1996; McNally 2007; Naughton 2007; Nee/Opper 2007). In China, institutional change did not lead to the radical replacement of one institutional arrangement with another, but to new combinations and layering that brought about significant processes of institutional conversion. Thus, the development of the People's Republic of China did not lead to the adaptation of a liberal model of capitalism but gave birth to a new form of competition-driven state capitalism. In what follows, one has to bear this constellation in mind because it has become (and is still becoming) a remarkable example of private sector evolution.

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8 In the 1980s and 1990s, a huge number of China's international investment projects served the aim of informally transferring property from state to private ownership (Ding 2000). This then represents another strategy for transforming the economy that cannot be taken into consideration here. These informal privatizations involved several forms of changing the de facto ownership of public assets, e.g. illegally shifting abroad money gained in China or siphoning funds from state-owned firms. It was conducted almost exclusively by cadres and managers (and their kin) in positions of advantage because they had the key resources for this form of marketization, i.e. permission to work abroad and investment capital.

9 The adaptable institutions in China point to links to the historical developments before 1978, with the reform process taking a socio-structural "side-step" from one form of bureaucratic class society to another. Although in Mao's era the CCP's language was more anti-capitalist, the bureaucracy was nevertheless privileged and exercised its exclusive right to distribute social surplus through its monopoly of the state. The fact that the power elites currently prefer the coexistence of private and state control over the means of production does not indicate a revolutionary new order in China but rather a change in the way it is ruled as part of a gradual process of institutional change. The objective of achieving economic growth by any means deemed necessary remains the same – only the instruments to accomplish it have changed.

### 3 Theorizing institutional change

How can we explain the significant changes in the Chinese economy and especially the ascent of a huge private sector? In the following sections, I attempt to show how experimentation *from below*, i.e. “wearing a red hat” (*dai hongmaozi*), whereby private companies mask their private-ownership by registering as publicly-owned companies, interact both with growth-oriented policies, at times crisis-induced, and political steering *from above* (e.g. the role of the state, the transformation of COEs and SOEs, new regulatory institutions), and produce a distinct business sector. Due to space constraints this paper examines only the emerging private sector’s bottom-up processes in detail.

To answer the question of how to understand the gradual transition within the economic system, Western political science tools for analyzing institutions are used which may aid research into China. These tools portray institutional development in an evolutionary manner, but emphasize its potentially discontinuous effects. As shown when applied to China, they may yield some interesting results (e.g. about the evolution of new markets) even for the non-China specialist.<sup>10</sup>

From an historical institutionalist perspective, institutions are described as “social regimes” or as ruling groups (“Herrschaftsverbände”) in the Weberian sense in order to capture their provisional, adaptable and hence contestable nature (Streeck/Thelen 2005). Institutional change derives from interactions among various actors. Thus, institutions are persistently contested and are often infused with ambiguities that can be exploited as sources and levers for change.

To avoid a formalistic analysis of institutions in capitalist systems, we must look at the distribution of power in society – both in the past, which led to the formation of institutions, and in the present, which is altering the appearance of institutions. This is necessary to see “behind” the formal structure of institutions and grasp the coalitions of actors that shape them. “The foundation [of a dynamic analysis] is one that conceives institutions above all else as distributional instruments laden with power implications” (Mahoney/Thelen 2010: 7–8). The creation of new institutions requires “institutional work” (Lawrence/Suddaby 2006) by a wide range of actors. In the case of China this includes both those with the capacities and skills to act as businessmen and those with a supportive role to the entrepreneur’s endeavors.

Streeck/Thelen (2005) conceptualize several ideal-typical mechanisms that capture the gradual transition of institutions in developed political economies that, over time, can cumulate into major institutional transformation. In the case of China, two mechanisms are particularly relevant: institutional *layering* and institutional *conversion*. Institutional *layering* describes processes leading to the often initially informal formation

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10 See for instance Fligstein (2001: 14) who complains that the evolution of new markets has been insufficiently considered in the social sciences.

of institutions in parallel and in interaction with existing institutions. These processes ultimately bring about changes that have a transforming effect on the existing institutions. To a certain extent, groups of actors with insufficient power are able to modify institutions in an oblique way. “Layering involves active sponsorship of amendments, additions, or revisions to an existing set of institutions” (Streeck/Thelen 2005: 24). An institutional *conversion* represents the use of existing institutions for new or alternative purposes. These processes can be set in motion by a shift in the environment that confronts actors with problems: “Different from layering and drift, here institutions are not so much amended or allowed to decay as they are redirected to new goals, functions, or purposes” (Streeck/Thelen 2005: 26). Even when the prescribed attributes of institutions remain in place, their substantive roles may change dramatically.<sup>11</sup>

As Tsai explains, those ideal types of institutional transition that to date have served mainly to analyze liberal democracies and OECD economies, can be applied to China: “The case of China demonstrates that even in nondemocratic settings where formal institutions appear to be imposed in top-down fashion rather than subject to popular suffrage, everyday actors may quietly appropriate formal institutions to serve their own ends” (Tsai 2006: 123; cf. Tsai 2007: 210). She then describes circumstances under which institutional change can in all probability be anticipated:

This is most likely to occur when there is a gap between the original intentions of formal institutions and the perceived needs and interests of local actors. At the same time, local state agents may collaborate with ordinary people by intentionally misinterpreting the formal institutions that they are supposed to uphold. Such bureaucratic deviance is more likely to be found in situations (1) where different formal institutions have conflicting mandates (a situation that facilitates ignoring one set of rules in order to comply with another); (2) where policy implementation is relatively decentralized; and (3) where local officials have convergent interests with local citizens in a particular policy area (for example, promoting local economic growth, hiding revenues from higher levels of government, protecting local industry, bending rules to attract external investment, and so on). In turn, these collaborative interactions may generate adaptive informal institutions that provide a powerful demonstration effect and prompt policy elites to transform key attributes of the official political and economic orders. (Tsai 2006: 123)

The following will show that China had an opportunity structure conducive to these circumstances.

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11 Other modes of gradual but nevertheless potentially transformative change such as “displacement”, “drift” and “exhaustion” cannot be considered here (cf. Streeck/Thelen 2005: 18–30).

#### 4 The strategy of “wearing a red hat” and the phenomenon of thickly embedded capitalists

Research on China based on both the “red hat strategy” and the rise of private entrepreneurs with close ties to the state and other “red capitalists,” illustrates how evolutionary change transformed the Chinese corporate sector. Specifically, it describes how innovative *informal* practices triggered the layering of formal institutions that eventually resulted in institutional conversions. Reform can be seen to have taken place over two phases.

##### The first phase of reform

Some historical background is valuable at this point. Facing the ruin of the Cultural Revolution, the elite increasingly accepted as valid whatever policies increased national output. The reform process was initiated for the survival of the party-state, not out of ideological principle. It resulted in a combative process of “trial and error” which led to hugely successful experimentation with markets and entrepreneurialism.<sup>12</sup> Ordinary people benefited from market penetration in the 1980s, especially under local market conditions. Whilst the resilience of the party-state prevented more radical transformation, this tentative constellation of “crossing the river by groping for stones” – borrowing from a metaphor commonly attributed to Deng Xiaoping – enabled adaptive informal institutions to play a vital role in the process of change. Two phases of gradual transformation can roughly be identified: the period from 1979 to 1989/1991 and the period from 1992 onward. In the first phase, agriculture was the predominant sector where the evolution of new markets began to take shape.<sup>13</sup> The industrialized urban sectors followed a little later (Shirk 1989).

A reduction in the planned system was not immediately accompanied by a widening of decision-making powers for business managers. In this context, the red hat strategy represented an effective evasive-maneuver. In the first phase of reform, it was the most popular practice whereby companies that were undeniably private, were able to mask their private ownership by formally registering as COEs, basically state-owned enterprises under the control of local governments.

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12 Nevertheless, the first phase of reform can in no way be seen as straightforward. Years of reform were at times jeopardized by both the pace of change, which differed from region to region, and by U-turns. The “Tiananmen intermezzo” led to a conservative rollback between 1989 and 1991 that was eventually brought to an end by the party’s reform wing only in early 1992. The success of further restructuring measures guaranteed that reforms from then on were seen as the norm.

13 Several continuities with older traditions could be observed that resonated with former innovative approaches taken in wartime base areas, in the early 1950s, and in the short resurgence of household and market activities in the early 1960s.

For a more precise analysis, Tsai distinguishes between formal and informal institutions.<sup>14</sup> Adaptive informal institutions are more likely to evolve in environments in which both the executors in formal institutions and the creators of informal adaptations have converging interests. Formal institutions are transformed in a process in which both state and non-state actors benefit from the existence of adaptive informal institutions that, in the process of transition from informality to formality, may gain intermediate levels of formality. Tsai backs up her argument with the example of how privately run companies were established in the guise of collective enterprises. Prior to 1988, it was forbidden to operate private enterprises with more than 8 employees. Registration as a COE or as a SOE was a way of founding larger private companies.

As shown, a process of institutionalization *through* informal practice can be detected in the evolution of the private sector. In the first phase of reform, and even up to the mid-1990s, the lack of official recognition led many businessmen to enter into an arrangement with the local authority whereby the company would become publicly owned and then subcontracted to them. “Estimates on privately owned collective enterprises range from one third nationally to as high as 90 percent in some localities” (Tsai 2005: 1136). Various terms were used to portray this substitute for a private firm: “pseudo-collectives”, “pseudo-SOEs” or “disguised private enterprises” to name a few (cf. Chen 2007: 58). The strategy of “wearing a red hat” brought advantages including favorable tax treatment and preferential access to bank credit. Local officials provided the firms with money, markets, land, and labor. It was not only rural TVEs (“Township and Village Enterprises”) that formed the backbone of the emerging private sector; the red hat strategy was also moving into urban areas.<sup>15</sup> A 1988 survey conducted in Wenzhou, which probably had the most highly developed private economy of the time, identified “45,000 privately owned firms of various forms under the banner of collective enterprises, but only 10 registered private enterprises” (Chen 2007: 57).

All in all, this practice of layering demonstrates an informal adaptive institutionalization that gradually altered the formalized institutional framework of company management. Over the course of time, the popularity and success of this practice led to support

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- 14 She defines adaptive informal institutions as regularized patterns of interaction that emerge as responses to the restrictions and opportunities of formal institutions. She also refers back to a special case of path dependency – “reactive sequences”. This identifies feedback mechanisms within institutions that generate the unfolding of paradoxical, unintentional consequences that in turn lead to the spread of a sometimes different, even opposite turn of development. The constant factor in this process of non-linear institutional development is a nature of change below that of systemic change: “That is, short of authoritarian breakdown, it is plausible that significant changes could nevertheless occur within the apparent limits of the existing political system” (Tsai 2006: 120).
- 15 In a nutshell, TVEs could develop rapidly once they received support from subnational governments in getting access to credit. They lost this privileged position in the first credit crises of the early 1990s and with it a key competitive advantage. This resulted in strong pressure for further reorganization.

both at the local political level, as being important for local economic development, and also among leaders within the power elite pushing for reform.<sup>16</sup>

As a consequence, several official political reforms in the late 1980s and early 1990s showed signs of an institutional conversion to replace the informal rules that had hitherto prevailed. For example, the discourse on private sector development in Wenzhou prepared the ground for new national regulations that improved the legal standing of private firms. “In 1988, the State Council issued the Private Enterprise Law and a subsequent constitutional amendment acknowledged the private sector as a supplement to the socialist public sector” (Chen 2007: 60). After the party’s reform wing finally halted the rollback between 1989 and 1991, the process of layering again began to quicken.

### The second phase of reform

From the early to mid-1990s, a large number of red hat employers – enabled by the CCP’s endorsement of China as a “socialist market economy”<sup>17</sup> and the enactment of a new Company law – began to register officially as private businesses (Chen/Wang 2010: 47).<sup>18</sup> Thereafter, the official private sector grew by an average of 35 percent per year. In lieu of the red hat strategy, the ascent of thickly embedded private capitalists and “red capitalists,” in the main private entrepreneurs who were CCP members, became critical factors in the second phase of transition:

Concerning thickly embedded private capitalists, the explosive growth of the private sector in some ways enabled a rags to riches rise of individual businessmen. At the same time, *The Hurun Rich List* – a Chinese equivalent of *Forbes* – which in 2010 ranked 1363 individuals with personal wealth of at least one billion Chinese yuan (US\$ 150 million),

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16 Several factors contributed to subnational political entities partially renouncing their control over wealth by transferring economic power to private actors. These factors included: the willingness of many local leaders to experiment with new methods of political development because of the decades of want and instability; the changes in central government tax legislation of the 1980s offering greater financial scope to compensate for possible losses resulting from local economic reforms; the consequences of transferring responsibility to managers and the increased efficiency this brought to company management to exert pressure for further modernization. Although legal proceedings against red hat practices were possible, these did not dominate the reform process. The success of the red hat strategy marginalized anti-market forces within the party-state. In reality no strict dividing line existed between legitimate business practices and illegal activities or corruption punishable by law.

17 The second phase of reform was heralded by the official acceptance of the “socialist market economy” during the 14th congress of the CCP in 1992.

18 Another example is the possibility of registering as “limited liability companies,” typically formerly COEs, of between 2 and 50 shareholders with a limited shareholder status (NBS 2007). They gained in importance, which was possible among other things by a clause in the Corporations Act of 1994 that permitted the reforming of “public” companies as “limited liability companies.”

reveals that “12 percent of those listed had been appointed to significant government advisory posts, handing them a powerful platform in a business climate that values official contacts” ([www.hurun.net/listreleaseen512.aspx](http://www.hurun.net/listreleaseen512.aspx)). This has also been the trend for the lower and medium echelons of the private sector. Many entrepreneurs – e.g. many of the businessmen in Zhejiang Province who work predominantly in the most competitive or the most marketized sectors – either belong to or have close ties to political bodies (e.g. the local People’s Congresses and People’s Consultative Conferences), or take part in village elections.

At the beginning of the most rapid phase of the private sector’s expansion, the transformation processes amounted to new private-public alliances between economic and political power elites that also manifested as actual personal unions. Empirical studies point out that closely interwoven politico-business interaction is typical not only for CCP membership<sup>19</sup>:

According to Ms. A [Owner of *AB Furniture Company*], the rapid growth of AB Furniture in the late 1980s endeared her to top government officials in the township where AB was located. Therefore, starting with strong political contacts at the local level, Ms. A became a representative in D city’s PCC and a member of one of D city’s district-level People’s Congresses in 1993. In 1996 Ms. A moved up a further step and became a representative in the D City People’s Congress. Finally, in 1998 Ms. A was invited to serve on the D City Quality Inspection Association. [...] Despite Ms. A’s refusal to acknowledge direct links between AB Furniture’s development and her political activities, [...] her political standing has yielded a standing in China’s political system for AB Furniture. AB thus enjoys greater respect from government officials and the bureaucracy works faster, better, and with less trouble. [...] Specifically, AB Furniture has benefited in the following rather direct ways from Ms. A’s political *guanxi* networks. First, the granting of official awards, such as the ‘famous brand name’ award on the provincial level, has generated free advertising and public relations for AB Furniture. [...] Second, Ms. A’s political status has made it easier for AB to access credit, especially in the early 1990s as it was very difficult for privately run enterprises [...] to take out big loans. Third, Ms. A’s political stature facilitated access to crucial market information. [...] Finally, Ms. A’s position on the D City Quality Inspection Association gives her indirect influence over the implementation of government policies in the furniture sector. (McNally/Guo/Hu 2007: 9–10)

Concerning “red capitalists,” one third of the *Hurun Rich List* is estimated to be made up of CCP members. The privatization of mainly small and medium-sized SOEs was another key contributor to private sector growth after the mid-1990s – between 1998 and 2006, the number of SOEs shrunk from 238,000 to 119,000 (Chen/Wang 2010: 44). This privatization was especially important in introducing a legalized process for privatizing state-owned firms (*gaizhi*) whereby managers could acquire their firms at a price based on recent profitability.<sup>20</sup> These cases of “management buy-outs” (MBO)<sup>21</sup> point

19 Hence it makes more sense to speak of state capitalism in a broader sense than, say, “cadre” capitalism.

20 The Chinese stock market also encouraged the privatization of large companies by opening up new avenues of capital procurement for SOEs from new shareholders.

21 As the following remark about a former SOE indicates, MBOs became increasingly common – “to the point that the headline in the city’s newspaper in January 2003 proclaiming the [firm’s]



to the fact that in many instances CCP cadres took on the role of “red capitalists.”<sup>22</sup> Even prior to the legalization of private property and “even though CCP members were not allowed to operate private businesses, it was apparent throughout the 1980s and 1990s that many were active participants in the non-state sector. Indeed, official surveys reveal an increasing proportion of self-identified CCP members among private entrepreneurs over time, such that only 7 percent of business owners admitted to being party members in 1991, but by 2003 over one-third admitted to being party members” (Tsai 2006: 132–133; cf. Tsai 2007: 72–104). Furthermore, as Dickson documents, the “larger the ‘sales revenue’ of a firm, the more likely its owner is a Party member”, and the more likely that Party organizations exist in their firms (Dickson 2007: 839–840). It is often those capitalists who operate the largest firms who “are the most likely to be involved in the political arena. Indeed, most of them [...] are more likely to support the [...] existing authoritarian political system rather than pose a direct challenge to it. This is a key element of the CCP’s strategy for survival, and so far it is working” (Dickson 2007: 852). “Co-opted” entrepreneurs state in surveys that the main reasons for joining the party are the economic advantages and connections to the political sphere (Dickson 2007: 841–842; Dickson 2003: 162–164).<sup>23</sup>

The shift from individual *control* to formal individual *ownership*, and the legal changes this involved, proceeded over several years. The Party leadership reacted by changing its attitude to private enterprise. This is evident from legalization on party membership for entrepreneurs (2001), the constitutional amendment on assurances for private property (2004) and finally the announcement on property rights (2007) that gave the same protection to both private and public property. Although private entrepreneurs in practice remained more or less absent from this process, the political power elite gave the *All China Federation of Industry and Commerce* credit “for representing the voice of private entrepreneurs and pushing for the private property clause to create a stronger political case for revising the constitution along the lines that they had been hoping for” (Tsai 2006: 139).

All in all, the remarkable ascent of China’s private sector led to a gradual, yet transformative change of policies. Where informal coping strategies once reigned, an acknowledged private sector now prevails. However, this process should not lead to prematurely

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imminent privatization simply used those three English letters ‘MBO’ instead of the equivalent Chinese characters, as if most newspaper readers would instantly recognize the English-language acronym for a management buy-out” (Chan/Unger 2009: 22).

22 This also applies to “red families” with high-ranking political backgrounds that help gain access to social resources. “Red families” are prevalent in the infrastructure, energy and real estate sector.

23 In the party apparatus itself there are two motives for wanting to co-opt entrepreneurs: on the one hand, the political class has an interest in cooperating with those social groups responsible for economic growth. This is particularly so for local party officials at regional authority level, whose career paths are directly linked to high growth rates; on the other ‘preventive’ hand, is the attempt to hinder the formation of organized opposition by exerting control in this form.

concluding that there has been a simple transition to a liberal market economy. Private property remains embedded in the (often local) political scene. The forms of recombinant property in China are characterized by an extraordinary influence from state actors and state entrepreneurialism, even when this property takes on new forms. This is shown in the next section.

## 5 The embedding of the enterprise in China

The corporate sector has to be analyzed against the broader background of market-liberal state capitalism with its multi-level governance, intra-regional competition, state entrepreneurialism and private-public networks on the one hand, and the politics of the central state on the other. This leads to the conclusion that the transformation process amounted to a hegemonic project of the “private-public” Chinese power elite. To avoid the trap of state-centered theories, with the Chinese Leviathan as a clever, forward-looking force shaping the economy (Yang 2004), one has to bear in mind the favorable external/regional/global opportunity structures that existed. This paper does not fully consider these but they did equip the ruling class with the means to cope with the hazardous path of allowing the private sector grow, and to muddle through the reform process of the 1980s and 1990s into what one may call an almost hegemonic rule of the 2000s.<sup>24</sup>

### Intra-regional competition, state entrepreneurialism and private-public networks

The bottom-up processes that stimulated the creation of a huge private sector were placing major pressure on different levels of the state. But due to the state’s entrepreneurial spirit and the sub-national competition between different state bodies, political administrations were able to act in a relatively compatible way.

In a sense, the structural interdependency between economic and political actors in capitalist systems in general assumes a particularly close correlation in China. Nevertheless, it has not assumed a monolithic form. It is impossible to understand the economy without reference to the diverse fragmentation below the level of the central state. The state in China could possibly best be defined as a “diffuse” capitalist developmental

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24 In the 1980s, East Asian countries – and, in a sense, their business sectors – became role models for China (see section 6). Additionally, the overseas Chinese fuelled the country with FDI and entrepreneurial spirit. In the 1990s, China became the most attractive location for production and entrepreneurial activities in the world when an over-accumulation of capital, classified as a capital investment crisis, hit the traditional production centers in the West. The reform process was, in contrast to the Soviet nomenklatura, mastered not only due to exceptional strategic skills or self-confidence but also due to many fortunate coincidences (cf. ten Brink 2010: 33–40).

state (McNally/Chu 2006: 54).<sup>25</sup> This also includes subnational governments which allow local enterprises to violate national labor laws. Since the subnational political levels have assumed the role of a local developmental state, they attempt to build settings conducive to success by creating incentives to stimulate economic efficiency in their territories by means of support, supervision of and direct involvement in companies. Good examples of this are the major investments in infrastructure, the development of “supply-chain-cities” and specialized single-product clusters in the coastal area (Gereffi 2009). Internal competition between subnational bodies vying with each other to attract investors has driven the rise of economic development. Government officials or state managers are thus often substitutes for entrepreneurship. This creative, though frequently corrupt commercial activity is in a way reminiscent of the Schumpeterian entrepreneur, but in a novel “state-capitalist” sense.<sup>26</sup>

Hence, the “state” and the “market” cannot be regarded as being mutually exclusive. Conventionalized, counter-juxtaposed concepts of private and state actors do not really clarify the situation in China. The opposite is the case in that, for example, legal forms – private versus state property – do not determine the scope of budget constraints on actors in the economy in the customarily assumed dichotomy of soft budget constraints for state companies versus hard budget constraints for private enterprises. As Walder wrote some time ago, the “analysis of soft budget constraints usually proceeds as if there is only one owner in the economy, ‘the state’, although in fact there are potentially as many owners of public enterprises as there are government jurisdictions” (Walder 1995: 268). Because they are subject to *competitive* pressures, the capacities involved in accumulation activities by local political institutions or local government officials in China have a lot in common with private capitalist companies or managers.

Although the frequently mentioned *guanxi* networks – closely personalized and affective forms of interaction and empathy – lend the Chinese economy a high degree of particularized coordination, it occurs within the confines of a competitive society.<sup>27</sup>

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25 The decentralization of regulatory power does not end at the provincial level. State power exists at different levels of the “local” and different types of regimes have been adopted by different localities. There is diversity between a form of diffuse developmental state and a corporatist state where the political authorities delegate influence to social groups who do not need to be formally recognized.

26 Interestingly, for Schumpeter, the entrepreneur is not necessarily a self-employed businessman, but anybody who takes on the entrepreneurial “function” of promoting “new combinations” (Deutschmann 2009: 5). As can also be seen in instances of innovation processes in Western countries, entrepreneurialism should be conceived as a more collective process in contrast to the Schumpeterian mainstream. Even when employers see the role of local governments to be of very limited and tangential importance to success, businesses are in truth shaped by numerous supportive institutions (Herrmann 2010).

27 The historical development of markets in general has been closely connected to processes of particularized coordination that in turn provided essential requirements for the functioning of competition (cf. Moellering 2010). China is thus no exception to the rule, although coordination has assumed a specific form.

As part of the growing monetization of social relations, these private-public alliances do not, as assumed by neo-classical theory, constitute a gradual transition to a “pure” market. Instead they are themselves to be regarded as a form of marketization. The commercial rationality is virtually synonymous with an ongoing development and cultivation of personal relations with local district bodies who have the resources that can promote business. From a political economy perspective, *guanxi* networks are seen as compensation for the historical absence of a regulative basis for market interaction. One function of this social interaction is its role as a *politicized* network – as microstructures of market-liberal state capitalism in which state and private actors (ultimately defined by the state) are bound together on several levels. What Western scholars would potentially call “productive incoherence”, in effect delineates some of the peculiarities of China and maybe its competitive advantage.<sup>28</sup>

Wank adds to this assessment the assumption that in the course of the reform process a change in the power configuration emerged between industry and government, with corporate strategies exerting more influence on the behavior of local political bodies. Greater dependency on the activity of entrepreneurs is manifest in a new kind of competition setup: “Previously, citizens competed to enter officials’ patronage networks. [...], now officials also compete with each other for links to larger private companies, with successful ones becoming shareholders and managers” (Wank 1999: 198). The organization of cooperation between the actors in society is reflected by changing coalitions for development. The result is not the automatic appearance of autonomous areas in civil society but rather semi-autonomous network communities of political and private actors whose economic development concepts are relatively independent of central government bodies.<sup>29</sup> Newly founded institutions at the local level (e.g. chambers of commerce or other non-governmental entrepreneurial civic associations) exemplify this trend.

This system of multi-level governance is subject to continuous bargaining and contracting within the administration, and between the administration and the business sector. At the same time, local institutional competition appears to be of utmost importance as a coordination mechanism (Krug/Hendrischke 2008: 94–95). Similar to the federal political structures and interregional competition that formed the backbone of industrial growth in the USA in the 19th century, the “de facto federalism” (Zheng 2007) in China stimulates the dynamics of its economy.

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28 Nevertheless, complementarity of institutions in the sense of a functional fit did not exist *ex ante*, but was discovered and developed *ex post*.

29 In contrast to liberal-democratic forms of capitalism, what has evolved in China is a specific network-form of dealing with contradictions within the pluralistic power apparatus. “Such pluralization does not occur through the formal trappings of electoral democracy, such as competitive parties and popular voting, but rather through the shifting power distribution and bargaining relations within networks” (Wank 1999: 202).

## The central state and its capacity to steer and reform from above

In a way, political institutions in China create the framework within which both the market oriented state capitalist and the private entrepreneur can operate. With regards to the central state, the government did not just adopt capitalist growth policies, individual entrepreneurialism and active support in privatizing SOEs. There was and still is another central-state role that is not to be underestimated: the provision of an overarching institutional architecture that accommodates competition. One political strategy regularly used by the regime to gradually initiate reform was to introduce change in only a few test areas, e.g. in Wenzhou or in Guangdong province, followed by a wider introduction of the policy when the test proved successful. Despite the fact that experimentation procedures have been delegated to local authorities, the central administration in Beijing plays an indispensable role in universalizing local innovations thereby generating coordination into the Chinese policy cycle (Chen/Wang 2010: 77–79). This capacity at macro level can be interpreted as *experimentation under hierarchy*: “The ‘federalism, Chinese style’ approach suggests that hierarchical governance has been replaced by administrative decentralization, jurisdictional competition, and central-local bargaining. Although these factors play an important role in central-local interactions, and local governments clearly feel more confident and secure today in making local policies, none of these changes has eliminated the weight of hierarchy and ad hoc central interference in China’s political economy” (Heilmann 2008: 11; cf. Zheng 2010). In other words, experimentation “from below” required patronage that might be the go-ahead from higher level policymakers through either non-intervention or encouragement and public backing.

Thus, the background of a competition-driven form of multi-level-governance in China and the anarchic processes concerning the (internationally embedded and dependent) economy should not lead to any premature conclusion that the central state is growing weaker (cf. Goldman/MacFarquhar 1999). In fact it is precisely its partial erosion in the first phase of reform that lent the central government and the rule of the Party new legitimacy from the 1990s onwards. One important example of this is the extractive power of the central state: in the second phase of reform, and particularly since the tax reforms of 1994, the central state has been able to recentralize resources to a considerable degree. In terms of its own modernisation, several waves of bureaucratic restructuring led to strong (supra)ministerial institutions such as the *Ministry of Commerce* (MOFCOM, see section 6) or the *National Development and Reform Commission*, which is now a hub in industrial development organization (Saich 2004: 121–136). Additionally, many of the large centrally-controlled state enterprises, which were restructured and are now mostly listed, were brought together from 2003 onwards under the *State Asset Supervision and Administration Commission* (SASAC). The founding of SASAC marked a milestone in the restructuring of state-owned business groups that act as a form of reliable consumer for numerous “red” suppliers and other private subcontractors (Ma/Lu2005; SASAC

2006).<sup>30</sup> In the state-controlled telecommunications sector, for instance, numerous privately owned “chip-design companies” produced a range of equipment for the Chinese 3G standard.

## 6 A note on favorable external opportunity structures for gradual changes in the trade regime

The development of agencies that subsequently created the MOFCOM in 2003 exemplifies the external sources of change in political institutions that need to be included with endogenous factors such as experimentation, new power constellations and ideological agendas (Chin 2007). In the first phase of reform, several existing governmental agencies were merged into the *Ministry of Foreign Economic Relations and Trade* (MOFERT), which from 1982 onwards embodied an amalgam of different and conflicting traditions within the CCP. But the turn towards “exportism” guaranteed an intra-bureaucratic compromise that initiated a process of institutional conversion. As older guiding principles of Maoism eroded, a new agenda for development appeared. The success of several East Asian economies helped in finding new ways of achieving growth. Japan, towering above its neighbors, was not alone in its success: “By the late 70s, South Korea had industrialized at a break-neck pace under Park Chung Hee and, most galling of all, the GMD regime in Taiwan was not far behind. The pressure of this setting on the PRC was inescapable” (Anderson 2010: 78–79). An understanding emerged that greater wealth could translate into internal legitimacy and regional power. Within MOFERT it took shape as a shift away from a policy of strict controls to one of preferential treatment for international economic activities. Henceforth MOFERT (later MOFTEC and finally, MOFCOM) became a form of intra-governmental avant-garde that propelled forward the exportist regime that was accompanied by a faith in dynamic markets, the positive role of individual entrepreneurialism, and new concepts of corporate governance. Mainland Chinese businessmen gained greatly from this constellation – be it as suppliers to big foreign corporations or from technical spill-over. The “Shanghai International Automobile City”, the biggest industrial cluster in China of components and parts suppliers, and mostly run by private Chinese businesses, emerged following the establishment of VW and GM; indigenous firms typically act as suppliers.

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30 The role of the state as an economic stabilizer for the private sector applies also to previous phases of reform: “[Since the 1980s] competition eroded initially high profit margins for state firms and induced the government, as owner of the firms, to become more concerned with profitability. The government experimented with better incentive and monitoring devices, and this experimentation improved state-sector performance. Nonetheless, the state sector grew more slowly than the nonstate firms that were entering new markets. [...]. Yet [overall] growth occurred with economic continuity that was attributable to the maintenance of a small planned sector as a kind of stabilizer, as well as to robust saving and investment that powered continued economic growth” (Naughton 2007: 97).

## 7 Conclusion: Institutional transformation and hegemony

The purpose of this paper was to integrate theoretical and empirical insights to show that the complex interaction of bottom-up and top-down processes provides a more precise picture of the development of the private sector in China. Chinese capitalism has thus maintained its distinctive private-public characteristics even when the prosperous private sector appears at first sight to be a liberal market economy.

With regard to the evolution of the Chinese society as a whole, gradual institutional change through the mechanism of layering and conversion has served not just the new private or semi-private entrepreneurs. Reform policy has also served the interests of the state bureaucracy and the Party – the CCP with its 70 million members acts as a form of catch-all party for capitalist modernization, and controls social transition while still functioning as a channel for the power elite (Brodsgaard/Zheng 2004; Shambaugh 2009). While the success of enterprise restructuring in China cannot be explained without including the favorable *external* opportunity structures, there remains the fact that until now, *internally*, the interdependencies between party, state(s) and entrepreneurs provided a strong alliance that created space for experimentation as long as growth rates remained high. This constellation produced new channels for upward social mobility through success at the market place. The prospect of individual upward social advancement – also promoted through the development of a consumer society – was a central source of motivation for entrepreneurs and for those wanting to become businessmen, and this contributed to relative social stability. This has been accompanied by a huge faith in progress that is reminiscent of the heydays of modernity. In other words, this disposition simultaneously provided both the required leeway for sometimes very difficult and socially disruptive adjustments *and* the motivation to risk entrepreneurial endeavors.

Thus, “communist” party-rule, a strong state<sup>31</sup> and “Chinese-styled market-liberalism” have not undermined one another. Far from it: the state class perceives industrial growth and technological upgrading as a means of buttressing CCP legitimacy and China’s national greatness (Gilley 2008). This corresponds, for instance, to the pragmatic policy of the “three represents”, i.e. the CCP claiming to represent not only workers and farmers, but also the interests of entrepreneurs, the so-called new advanced productive forces. While in 2004, 35 percent of entrepreneurs in China were party members, less than 6 percent of the total population belonged to the CCP. Therefore, rather than seeking autonomy, many private capitalists have pursued a combination of institutional and affective ties that “thickly embed” them with the party-state (McNally/Wright 2010). The increasing socio-economic mobility of entrepreneurs has to an extent been facili-

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31 The state’s prominent role is also due to several “non-economic” spheres in which the state and its agencies dominate social life, i.e. in politics, in creating numerous civic and social organizations, and in attempting to establish environmental protection systems. At the same time, a process of societal pluralization and increased autonomy in everyday life could be observed in recent years, in which the CCP increasingly retains its viability in a consultative but authoritarian way.

tated by their ties with the regime so they have had little reason to criticize it. On the contrary, the common interests of the state bureaucracy, the state, and private capitalists frequently lead to common viewpoints. “In contrast to the popular perception that privatization is leading inexorably to democratization, [...] the most recent survey data suggest that [private businessmen] are increasingly integrated into the current political system. [...] This again suggests that the growing shared interests of government and business are creating an environment that supports the status quo, rather than one in which businessmen are motivated to press for change” (Dickson 2007: 852).<sup>32</sup>

In terms of critical political economy, the Chinese ruling elite was capable in the second phase of reform of forming and consolidating a *historical bloc* – including the urban middle classes and intellectuals – and transformed its dominance into *hegemony*. The emergence of a new economic regime and a new “economic imaginary”, which is articulated in state and private-public projects, underpinned a relative societal coherence. Gradual institutional change through layering and conversion would not otherwise have proceeded to the same extent. The objective of a “harmonious society”, as expressed by the current leadership, could then be interpreted as an attempt to renew social compromises that are crucial to maintaining hegemony and upholding the path of reform. Because markets, however, tend to have a destabilizing impact on their institutional framework and resist institutionally imposed stabilization and control, a harmonious society may prove difficult to achieve in the years to come.

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32 This point should not be overstretched since the logic of competition always puts this into perspective. This is why Marx called the ruling classes in modern societies a “band of warring brothers.”



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