
Institutional Change and Economic Transition: Market-Enhancing Governance, Chinese-Style

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Abstract

This study introduces a coherent comparative concept of governance, applies it to China, and elaborates to what extent the Chinese institutional matrix exhibits characteristics of a market-enhancing governance structure (MEGS). It is argued that a subtle interplay of political and economic institutions created a stable and viable politico-institutional foundation which made China's unorthodox transition strategy politically feasible and economically effective. The paper concludes with an assessment of the quality of the overall Chinese governance structure and its expected implications for the future transition process.

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1. Introduction

In 2005, China's Gross Domestic Product (GDP) was more than eight times the GDP in 1978. Despite the Asian crisis and the world recession at the beginning of the new millennium, annual economic growth was consistently higher than 7% since 1996, and the Asian Development Bank (ADB) (2006) expects real GDP growth to reach 9.5% in 2006. Foreign direct investment increased from US\$ 57 million in 1980 to US\$ 52.7 billion in 2002. Since 2000, gross fixed investments have grown at a rate exceeding 10% per annum. The number of the absolute poor decreased from 250 million in 1978 to less than 30 million today. Life expectancy has increased from 63.2 years (1970-75) to 71 years (2000-2005). In 1998, China graduated from being classified by the World Bank as a low-income country to a middle-income country.²

From the viewpoint of orthodox economic theory, China's success, particularly in comparison with other advanced transition economies, implies two puzzling observations: First, China did not apply theoretically-derived policy recommendations. On the contrary, Chinese authorities followed an unconventional, gradual, and pragmatic approach to reform, decentralize, and eventually transform the economy. Theoretical approaches which could explain why non-orthodox policy measures worked effectively in China were developed *after* it had become apparent to academics and policy analysts that these measures materialized and contributed to realize a long-term, sustained growth trajectory. Notable examples of these non-orthodox ingredients to the Chinese transition process include the dual-track approach to industrial restructuring, the establishment of special economic zones, or the priority given to create competitive structures while postponing large-scale privatization of state-owned enterprises (SOEs). Secondly, contrary to Central and Eastern European transition economies the Chinese transition has been taking place without political democratization.

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² See, e.g., Qian (1999a), Asian Development Bank (2006 and 2002a), and UNDP (2004).

Not having had to cope with an economic and political transformation at the same time, it is usually argued that China has escaped the dilemma of simultaneousness. In fact, a democratization process according to Western standards has been absent in China. But it has to be noted that even in China, as an impetus to and a consequence of economic transition, a gradual, though far-reaching change of institutions has taken place – a market-induced transformation of the Leninist state (Heilmann 1998) and hence the emergence of a post-socialist transition order. This change entailed substantial alterations of the country's governance structure.

Building upon the emerging research on the importance of governance and institutional change for economic performance in transition and less developed countries, this study reinforces the growing consensus that economic reforms and transformation will be ineffective in the absence of an appropriate institutional foundation.³ Instead of establishing minimal states, this strand of the literature emphasizes the need for governments which are capable of formulating, implementing, and enforcing reforms (Grindle 1997; World Bank 1997). A country's governance structure displays the interconnection between different formal as well as informal political and economic institutions. Since institutions shape the incentive structure within a society, the quality of governance determines whether or not the formulation, implementation and enforcement of reforms will be effective.

The objective of this study is to introduce a coherent concept of governance⁴, to apply it to China, and to elaborate to what extent the Chinese institutional matrix exhibits characteristics of a market-enhancing governance structure (MEGS). It will be argued that a subtle interplay of political and economic institutions created the foundation for the feasibility and efficacy of China's unorthodox transition strategy and eventually the country's economic success. The paper is organized as follows: The second chapter discusses the vital role of the state for the economic transition process and emphasizes the need to craft a flexible MEGS. Against this conceptual background, the Chinese institutional matrix is analyzed in the third chapter in order to investigate to what extent the Chinese governance structure exhibits characteristics of a MEGS. The paper concludes with an assessment of the quality of the overall Chinese governance structure and its expected implications on the future transition process.

2. Market-enhancing governance

Effective economic transition presupposes credible commitments that political promises are actually delivered to citizens and investors. Moreover, it crucially depends on the administrative capacity of state institutions, the relationships between policymaking entities and different strata of society, and the technical and political ability of policymakers to formulate and implement the policies which the political leadership seeks to pursue. In this regard, the *governance structure* underlying the process of policymaking is of utmost importance.

³ See, e.g., North (1995), Ahrens (2002), Feng (2003), Kaufman et al. (2003), Keefer (2004), and Wagener (2004).

⁴ Although the notion of governance may reasonably refer to public governance as well as corporate governance, this paper essentially focuses on the former and relates to the latter only implicitly in Section 3.4. The underlying reason is that this study aims at understanding the politico-institutional foundation of market-oriented policymaking in China. An additional comprehensive and explicit account for corporate governance issues in China would be beyond the scope of this paper; with respect to this question see, however, e.g., OECD (2005).

2.1 The concept of governance

Recent research on governance and its impact on economic performance significantly increased our understanding of the constituent characteristics of a politico-institutional foundation of policy formulation and implementation.⁵ Country experiences as well as empirical cross-country studies showed that it is not the regime type per se (i.e., democracy or authoritarian regime) which is the key to successful economic transition and growth. Rather the quality and the context-specificity of institutions and their interplay as well as the interrelations between state and private actors proved to be crucial determinants for economic transformation. Overcoming the pretended dichotomy between markets and states, numerous scholars perceive institutional variety as an integral element of policymaking that links the activities of public and private actors.⁶ This implies that public goods, including institutions crafted and enforced by the state as well as public policies, are the outcome of the interrelation and exchange of multiple actors. Furthermore, North (1990, 1997) and his followers have convincingly argued that it is primarily institutions which provide individuals with specific incentives for their action and affect political and economic exchange. Institutional arrangements also determine the formation and implementation of policies. From that perspective, a proper understanding of governance, that relates to policymaking and economic performance, needs to go beyond the narrower conception of corporate governance or the notion of policy management. While corporate governance in a *Williamsonian* understanding relates to a microperspective on the firm and on private ordering and policy management is frequently limited to public sector management, the following considerations are based on a concept in which governance is defined as “the capacity of the institutional matrix (in which individual actors, organizations and policymakers interact) to implement public policies, enforce rules and regulations, and to improve private-sector coordination”.⁷

Hence, governance is *not* a synonym for government. Rather, it relates to institutions associated with governability and accounts for institutional variety as well as its importance for state capacity in conducting policy reform (Ebner 2005). In this context, governance clearly focuses on the quality of public policy and its impact on economic performance and transformation. Thus, a country’s governance structure consists of institutional arrangements and political processes of formulating and implementing feasible policy goals and applying appropriate instruments, thereby relying on the coordination of diverse actors in the public as well as the private sector. From that perspective, a governance structure exhibits characteristics of a collective good. It is provided by various actors which influence public policymaking in a top-down as well as a bottom-up manner. These actors may basically include public and private domestic organizations such as government agencies, administrative units or companies and trade associations. They also comprise external actors like the International Monetary Fund (IMF), the World Trade Organization (WTO), foreign governments or multinational enterprises. The interaction of these actors affects institution building and enforcement in different areas including the management of the public sector, the interface of the public realm and the private sector, the formation of economic institutions as well as the

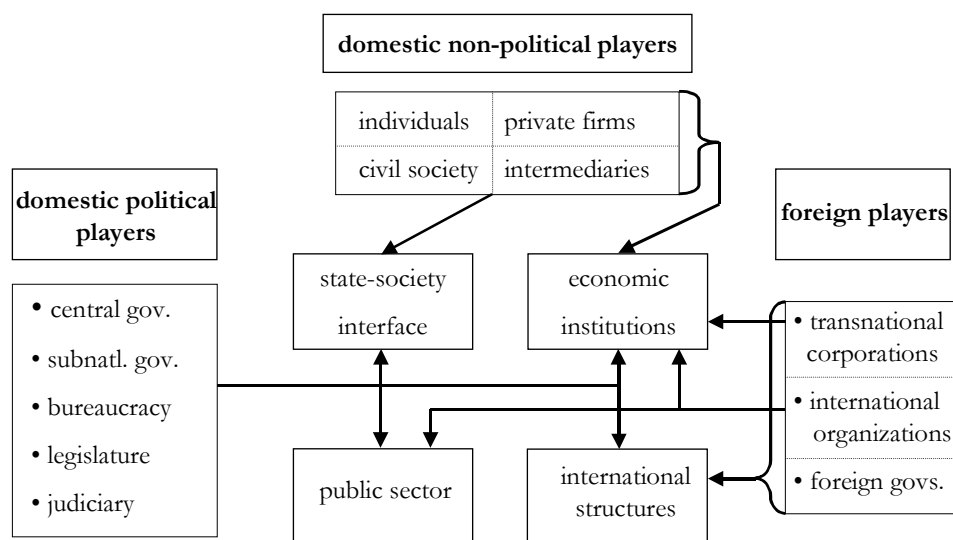
⁵ See, e.g., Kaufman et al. (1999, 2003) and Ahrens (2002).

⁶ See, e.g., Dutt et al. (1994), Klitgaard (1991), Root and Weingast (1996), Streeten (1993), Stiglitz (1999), and World Bank (1997).

⁷ Ahrens (2002, p. 128); in this context, see also Williamson (1985, 1995) and Ebner (2005).

institutional design which determines how a country is integrated into international structures. All of these areas are important for the initiation, formulation and implementation of transformation policies (see Figure 1). These actors' activities are linked through formal and informal institutional arrangements for cooperation, coordination, and consultation. Usually, the state is the main and most powerful actor due to its coercive power and its capacities for institution building and enforcement. In addition, the *political and administrative institutions* of a governance structure play a key role, because they determine how different actors are involved in political processes and what kinds of economic reforms are politically feasible. But the state is not a monolithic entity – it is itself a complex, multifaceted organization the internal structure of which represents a complicated nexus of institutions which provide incentives (and disincentives) for political decision makers and bureaucrats to formulate and implement public policies (Ahrens 2002, Ebner 2005).

Chart 1. A stylized model of governance: realms and players



A market-enhancing governance structure (MEGS) allows for a high degree of policy adaptability, is based on an adaptively efficient institutional matrix, and yields innovative and growth-promoting outcomes. A MEGS shows, contingent on the stage of a country's politico-economic development, comparatively high degrees of accountability, participation, predictability, and transparency resulting from interdependent and mutually reinforcing institutional and organizational arrangements. These include a high degree of state capability as a precondition to enforce rules and implement stabilization, innovation and other policies, capacity building in the public and private sector as a precondition for technically, administratively, and politically implementing public policies, the establishment of key economic institutions for enhancing and sustaining markets, and the creation of a public-private interface that improves cooperation, coordination, and consultation between policymakers, research organizations, and private firms.

2.2 The constituent pillars of a MEGS

Distinct pillars constituting a MEGS can be distinguished⁸: First, the state needs to be sufficiently strong to implement policies and protect economic actors' rights and to prevent state capture by narrow interests; secondly, the state needs to be sufficiently limited to prevent predatory behavior of politicians and public officials; thirdly, it is important to strengthen capacity building in the public sector in order to create appropriate technical and administrative skills; and finally, principal economic institutions have to be established which provide the basis for market exchange and promote economic growth.

2.2.1 Creating a strong state

A MEGS consists of political and economic institutions. A country's political institutions determine which reforms are politically feasible and who is involved in the reform process. Thus, these institutions have an indirect, though substantial impact on the outcomes of reforms (Evans 1995; Ahrens 2002). Apart from more general political institutions, the success of reforms particularly depends on state capacity and capabilities and corresponding possibilities to contain the influence from pressure groups by aligning their interests with collective interests (World Bank 1997).

In many transition economies, the state lacks the capacity to implement and enforce policies and to protect property rights. In addition, it is not capable of preventing public officials from corruptive behavior and influential pressure groups from rent-seeking and distorting economic policies. Such a state is weak in Myrdal's (1989) sense.⁹ Moreover, in order to exploit specialization advantages and to cope with the complexity of structural reforms, the government needs to delegate authority to the public administration, subnational jurisdictions, and private actors. This, in turn, creates principal-agent problems. The delegation causes information asymmetries and bears the risk that the agents do not act in the interest of the principal (the government) and rather pursue their own interests. Without a systematic control over public officials, policy and institutional reforms might be implemented by one bureau while another one counteracts them. As a consequence, economic agents would no longer trust in the government's ability to implement and enforce the policies according to its announcements. This may result in a system in which corruption and nepotism prevail so that the weak state might turn to become a predatory one (Root 2001). Hence, a strong state is required that ensures stable, transparent, and predictable policymaking. Within a strong state apparatus, government officials and policymakers show a high degree of autonomy i.e., they act sufficiently unaffected by vested interests of private actors. In addition, a strong state is rather centralized to overcome principal-agent problems of policy implementation. A further important factor is the establishment of a highly capable Weberian-type public administration acting relatively autonomously (Evans 1995).

⁸ For a detailed discussion of these pillars see, e.g., Weingast (1995), Evans (1995), Grindle (1997), Heilmann (2000), and Ahrens (2002).

⁹ Regarding these deficiencies in numerous PSCs, see, e.g., the recent Transition Reports of the European Bank of Reconstruction and Development.

2.2.2 Limiting the state

“The fundamental political dilemma of an economic system” (Weingast 1995: 1) is that a strong government which guarantees citizens’ rights is also able to violate those rights. In order to mitigate the problems arising from this dilemma, a *strong but limited* state is required.¹⁰ The state has to be sufficiently strong to protect economic rights but at the same time constitutionally or otherwise restricted from infringing upon these rights. Consequently, institutional safeguards need to be put in place so that policymakers’ hands are tied when it comes to altering laws and regulations at the expense of the business sector or society in general, and this is not only to be assured for current, but also for future governments. This is achieved by designing political institutions in a way that incentive structures for politicians and public officials are established which ensure that it is less costly for them to stick to the rules of the game than violating them (Root 2001). In this way, the necessary credible commitment of governments to sustained market-oriented policy reform is secured. This commitment is regarded as the key determinant of successful economic transition (Borner et al. 1995).

In order to reduce opportunistic behavior of government officials and bureaucrats, horizontal institutional checks (e.g., in the form of separation of powers) as well as vertical institutional checks (including decentralization and federalism) may be conducive. With respect to the former, the agenda control of one agency may be limited by giving veto power to at least one other public or private organization. In addition, an independent judicial system can contribute to make governments and bureaucrats stick to the rules of the game. Institutions that establish the rule of law contribute to lower transaction costs if they foster transparent and predictable economic and political processes and limit corruption and rent-seeking. It creates the necessary credibility of the government in providing private actors with incentives which are the foundation for economic growth (Qian 1999a). In addition, independent watchdog organizations may contribute to enhance government accountability (Ahrens 2002). With respect to vertical institutional checks and balances, the concept of market-preserving federalism (MPF) is expedient. It is based on five conditions: C1) a clear separation of authority between national and subnational governments; C2) undisputed authority of the subnational governments over their regional economy; C3) the surveillance of the common market by the central government; C4) hard budget constraints for the central and the subnational governments; and C5) institutionalized stability of the federal structure. Montinola, Qian, and Weingast (1995) argue that these institutional arrangements limit the interference of governments in market transactions and create incentives for local governments to promote economic growth in order to increase the tax base.¹¹

¹⁰ This is in line with McIntyre’s observation of a U-shape relation between institutional configuration and governance which means that both a centralized and a fragmented political framework are unfavourable for good governance, see McIntyre (2003), p. 160-62.

¹¹ See Montinola, Qian and Weingast (1995), pp. 54-55; Cai and Treisman add that the interregional competition for capital can also cause local governments to shelter local firms from federal taxes, federal courts and bankruptcy regulation so that central law enforcement is weakened; see Cai and Treisman (2002), pp. 841-42; Blanchard and Shleifer (2000) agree to the concept of MPF but emphasize that political centralization appears to be necessary to some extent in order to align the interests of policymakers at the national and subnational level and hence to avoid regionalist policies.

2.2.3 Creating capacity for policy enforcement

A further key constituent of a MEGS is capacity building. While narrow definitions interpret capacity building as improving the skills of the public administrators, broad definitions risk blurring the edges between the notions of capacity building and governance (World Bank 2000). For the purpose of this study, capacity building incorporates those activities which enhance the public sector's accountability, predictability, and transparency. Capacity building is a major means to improve the effectiveness and efficiency of governmental activities and encompasses institutional reform, organizational strengthening, and human resource development. Institution building refers to replacing existing institutions with more efficient ones; organizational change relates to altering organizational structures to better suit the new set of institutions; human resource development refers to training people to act in line with new institutions and organizational structures (Grindle 1997). The objective of capacity building is to enhance the credibility of the public sector through the creation of a professional public administration that establishes, complies with, and secures the rule of law, dissipates relevant information, and effectively pursues the tasks it has been given authority to do. Essential institutional arrangements, including the introduction of hard budget constraints and meritocratic elements within the bureaucracy, are to be prioritized when conducting institutional reform (Ahrens 2002).

2.2.4 Building economic institutions

Formal economic institutions constitute the fourth pillar of a MEGS because they determine the incentives for economic activity in a country. Therefore, the answer to the question as to why some countries are more developed than others is closely related to the set and the quality of a country's economic institutions (Acemoglu et al. 2004).

The German *ordo-liberal* school analyzes the institutional framework of a market economy according to distinct constituent principles, all of which support the functioning of a market-price system as an economy's main allocation mechanism (Streit and Wohlgemuth 1997; Wagener 2004). These principles comprise the protection of private property rights, the guarantee of free market entry and exit (open markets), the freedom of contract, the stability of the monetary system, liability for economic actions, and the steadiness and predictability of economic policymaking (Eucken 1952/1990). The state should only intervene in the market if the intervention is market compatible and does not harm the price mechanism. In order to maintain a functioning economic and social order, regulating principles complement the constituent ones. Market failures are to be corrected through anti-trust institutions or interventions in order to guarantee the functioning of the price mechanisms. In order to maintain social justice, income distribution needs to be corrected, social safety nets to be installed and employee rights to be protected (*ibid.*).

With regard to economic institution building, policymakers can basically follow two different strategies. First, a government adopts the economic institutional matrix from a 'best-practice country'. Such a strategy has often failed in history, because social norms, values, and beliefs change more slowly than formal economic and political institutions and thus impede a big-bang approach of institutional change (Roland 2004). Alternatively, governments may use local knowledge to build economic institutions in a

more gradual process. This might, on the one hand, meet country-specific needs and be compatible with persisting informal institutions, but on the other hand, it does not capitalize on experiences of developed nations with institution building.

3. China's governance structure

The previously discussed institutional arrangements are usually conceived as the core pillars of a MEGS. All reforms to craft a flexible MEGS have the purpose to promote the adaptive efficiency of both the polity and the economy. However, the ultimate objective is to overcome problems which are related to transition and poor economic performance. For this purpose, the governance structure has to be geared to the needs of each individual country in order to take account of existing informal institutions and the priorities of citizens with respect to economic, political, and social change. Thus, the governance structure needs to be sufficiently flexible in order to foster institutional innovation and to adapt to changes in the political, economic, international and technological environment. Due to the preceding arguments, the concept of a MEGS with its constituent pillars represents a suitable framework for the analysis of the highly complex institutional foundation of the systemic transition in China.

China's gradual economic transition process has not yet come to an end. Two major phases can be distinguished: The first phase (1978-1993) is marked by gradual reforms which followed the objective to improve the efficiency of the command economy. The second phase started with the decision of the Third Plenum of the 14th Party Congress in September 1993 to transform China's economy into a *socialist market economy*. The objective was to build market institutions and to create a rule-based market economy (Qian 1999a). In order to assess the overall effectiveness of the emerging governance structure, we will explicitly analyze all four pillars that constitute a MEGS.

3.1 The strength of the Chinese state

As history has shown, Chinese politics strongly depend on the character and the political program of the party leader.¹² As a result of this dependency and the dominance of the hierarchically organized Chinese Communist Party (CCP) in politics and society it seems expedient that the Chinese state is strong. But the CCP is not a monolithic bloc and authority is based on informal rather than institutionalized power. Throughout the 1980s, Deng Xiaoping's faction (which had joined forces to shoulder aside Hua Guofeng) displayed little coherence and new factions emerged which caused cleavages within the CCP.¹³ As a result, the reform process followed a path of *fang* (letting go) and *shou* (tightening up) which means that liberal reforms followed conservative counteraction. China's paramount leader, Deng Xiaoping, was in the centre of the process, "manoeuvring his way through successive economic cycles, ideological struggles, terminological disputes, and political wind shifts" (Baum 1994: 16).

¹² Mao's Great Leap Forward and his Cultural Revolution had devastating outcomes. In contrast, the politics of Deng Xiaoping have blessed China with economic growth, see Qian (1999a), p. 6.

¹³ See Baum (1994), pp. 9-10; factions are informal nexus of personal relationships and are often not fixed in ideology or membership. Deng's faction included a wide range of political orientation from economic pragmatists to political reactionaries and ideological conservatives.

Due to political cleavages and the power of bureaucrats¹⁴ Deng's 1978 reforms had to be gradual.¹⁵ Three mechanisms of Deng's strategy to mitigate opposition of the central bureaucracy seem to be outstanding: first of all, Deng increased the power of the provincial officials to build a counterweight to the central bureaucracy; secondly, Deng's strategy was not to create reform losers; and thirdly, Deng managed to start reforms in sectors where pre-reform rents were low and potential opponents faced incentives for promoting growth (easy-to-hard sequence of reforms) (Shirk 1993).

At the end of the 1980s, increasing corruption and inflation caused student protest against the regime which culminated in the military crackdown on Tiananmen Square in 1989 (Lieberthal 1995). Many reformists were forced into exile and China experienced a period of neo-conservatism at the beginning of the 1990s.¹⁶ But despite his weak health Deng rescued market reforms against his octogenarian conservative comrade Chen Yun with his tour through South China in 1992 (Baum 1994). In essence, despite the internal incoherence of the CCP during the first phase, Deng was able to enforce most of its economic decisions.

In November 1993, the party leadership decided to move towards a rule-based economy with market-enhancing institutions which would finally curb the fang-shou fluctuations. In the course of this second phase of reforms, state capacity was reduced as most public officials were primarily occupied with business activities and earning money. In consequence, Jiang Zemin (who became the paramount leader in 1994) tried to strengthen the power of the CCP and take back some of the de facto economic decentralization of the early 1980s (Saich 2001). Although Jiang's fight against corruption was successful in the short-term, large corruption scandals at the end of the 1990s and the beginning of the present decade portend the failure of these attempts (ibid.). When Jiang's second term ended in 2002, he used his retirement as a means of bargaining in order to push through his appointments for the Politburo and thus consolidate his power (Dittmer 2003). Hu Jintao was elected General Secretary (GS), Wen Jiabao Prime Minister, and Jiang Zemin still holds on to the reins as chairman of the Central Military Commission (CMC). As increasing inequality was threatening the political stability in 2003, Wen Jiabao and Hu Jintao announced to create more equitable growth and increase living standards in the rural areas.¹⁷ Summing up, the Jiang Zemin era has been marked by a recentralization of power and the building of market institutions. Although state capacity somewhat deteriorated due to increasing corruption, government effectiveness is still moderate (Kaufmann et al. 2003). But the high amounts of FDI flowing into the country indicate that the strength of the CCP appears to be credibly limited.

¹⁴ Although severely weakened during the period of the Cultural Revolution (1966-76) the bureaucracy was still powerful, see Shirk (1993), p. 334.

¹⁵ See Nuhgton (1995), pp. 8-9; Nuhgton termed this process "growing out of the plan".

¹⁶ See Baum (1994), pp. 16-21. Proponents of neo-authoritarianism rejected drastic privatization measures and promoted *realpolitik* as a major principle for policymaking.

¹⁷ See The Economist Intelligence Unit (2004), p. 18; the government set up a rural revival package which includes the reduction of tax burdens for farmers, improvements in health care and education, increases in subsidies to farmers, facilitating labor mobility and paying more attention to the people still living below the poverty line.

3.2 The limitations of the Chinese state

3.2.1 Horizontal separation of powers and elections

In China, the CCP and the state are still closely intertwined. As the role of the state organs is to implement party policy, a democratic separation of powers is absent.¹⁸ Ultimately, the highest organ of the CCP, the Politburo, and its Standing Committee constitute the power cell of the Chinese political landscape (Saich 2001). These institutions are headed by the GS who sets the political agenda and determines the policies of the government (including its highest-ranked organ, i.e. the State Council led by the premier) through small functional groups (*gateways* or *keuo*). According to the 1982 Constitution, the National People's Congress (NPC) and its Standing Committee are the main legislative body with the power to elect the President and to decide on recommendation of the President on the appointment of the Premier of the State Council. But although the NPC and its Standing Committee gained importance throughout the 1980s and 1990s, *de facto* power of the NPC is still limited (Saich 2001). Although the legal system was re-established after the anarchistic Cultural Revolution, the judicial system is still strongly influenced by the CCP. Concluding, formal political institutions hardly represent effective checks on the Party leadership. Therefore, internal limitations within the CCP are to be analyzed.

3.2.2 Internal limitations within the CCP

The CCP is hierarchically organized following Leninist principles.¹⁹ On each level, Party Congresses elect Party Committees which in turn elect Standing Committees. In return, Party Committees are accountable to Party Congresses.²⁰ In theory, there are limits on the Committees and Standing Committees as they are elected by the Party Congresses. But, in fact, policy decisions as well as personnel decisions are made on the highest level through informal channels. Party Committees merely rubber-stamp decisions of the Standing Committees. The Politburo members are formally elected by the NPC, but *de facto* chosen in opaque informal bargaining arenas between the most powerful politicians. Ultimately, informal relations (*guanxi*)²¹ and informal power²² are the main determinants of policymaking in China. Thus, the accountability of the ruling elites is very low.

¹⁸ See Lin and Hu (2003) and Saich (2001), p. 107.

¹⁹ Following Leninism, the Party has the leading role in politics, society and the economy. The two main Leninist principles comprise democratic centralism and collective leadership. The former implies that party members shall dispute over policy issues. But once the party made a decision by majority vote, every party member had to follow. Collective leadership refers to the institutional limitation of strong individual leaders on all party levels by group decisions; see Saich (2001), pp. 80-81.

²⁰ The highest national institutions are the National Party Congress, the Central Committee and the Politburo which itself has a Standing Committee; see Saich (2001), pp. 80-106.

²¹ In the Chinese society and in politics individuals endeavour to build up *guanxi* with powerful and influential persons. In consequence, in politics many people are linked through patron-client relationships. Due to strong dependence on *guanxi* disputes between factions can easily infect the whole CCP and create political instability; see Saich (2001), pp. 83-84.

²² The importance of informal power is illustrated by the strong influence Deng still exerted after he had conceded formal power in 1989 (particularly with his Southern tour in 1992), see Baum (1994), p. 8.

In addition, the People's Liberation Army (PLA) still plays a key role in politics as the PLA is the last resort for defending the rule of the communist regime.²³ Since Mao's rule the Party has been dominant over the PLA.²⁴ But as the third and fourth generation of political leaders (i.e., the generations of Jiang Zemin and Wen Jiabao) do not have personal ties to the PLA (unlike Mao and Deng), an increasing institutional separation between the PLA and the Party can be observed (Shambaugh 2001).

During the last 25 years various attempts have been made to promote formal institutional arrangements, particularly in order to tackle the political instability caused by the power struggles in the course of the succession of political leaders.²⁵ Through promoting the rule of law, reforming the bureaucracy, decentralizing power, curbing the duration of tenure and introducing intra-party elections on a small scale Deng attempted to build a socialist democracy, Chinese-style. But his project to cut off the state from the party was rejected in 1989 and his recruitment of younger leaders for the high party organs failed.²⁶ Due to increasing corruption in the bureaucracy, the growing heterogeneity of the CCP, and the lack of personal authority of the technocratic third- and fourth-generation party officials (unlike the revolutionist Deng and Mao), Jiang searched for new ways to perpetuate his legitimacy. Thus, a tendency away from informal bargaining towards increasing institutionalization is under way. A third way of intra-party-democracy is followed which includes further strengthening of Party committees on all levels with promoting majority vote and collective leadership, the promotion of party-internal elections, and the strengthening of Party congresses.²⁷ Although these measures improve the internal accountability of the Party leadership, they do not significantly improve accountability to the Chinese people. In addition, the standard ideology²⁸ is a major obstacle for institutionalization of the CCP and establishing the rule of law in China. After Deng had shifted the legitimacy of the CCP from being the "vanguard of the proletariat" (Lin 2003: 43) towards creating economic growth and prosperity, Jiang Zemin added the *Three Represents*²⁹ in 2001. This opened the Party to all societal strata (including private businessmen). This will change the composition of the CCP and could ultimately limit the power of the state (Lin 2003). In essence, despite attempts for institutionalization, informal relations still determine Chinese politics, and formal intra-party institutional limits are still rare.

²³ In addition, in the course of the One-China policy with respect to Taiwan the PLA plays an important role, see Swaine (2004), pp. 40-41.

²⁴ Already in 1929 Mao introduced the principle that "the Party commands the gun and the gun must never be allowed to command the Party", Mao (1975), p. 224. Although Deng reduced the power of the military during the 80s their importance in the political arena gained after the quashing of the Tiananmen students protests; see Bramall (2000), p. 443-43.

²⁵ Mao's death was followed by a 3-year power struggle between Hua Guofeng and Deng Xiaoping, and also Deng's succession was overshadowed by severe power struggles; see Heilmann (2002), p. 55.

²⁶ During most of the 1980s China was ruled by a gerontocracy of septuagenarians and octogenarians in the Politburo. Since 1997, the cut-off age for Politburo members is 70; see Dittmer (2003), p. 24.

²⁷ For an extensive discussion of these measures see Lin (2003), pp. 47-62.

²⁸ The legitimacy of the post-Mao party was officially "based on the so-called one centre (giving top priority to economic development) and 'two basic points' (adhere to reform and openness, and adhere to the 'four cardinal principles' – Party leadership, socialist road, proletarian dictatorship, and Marxism, Leninism, and Mao Zedong thought); Lin (2003), p. 41.

²⁹ The *Three Represents* mean that the CCP should represent China's most productive forces, most advanced culture and the concerns of the Chinese masses; see Lin (2003), p. 39.

3.2.3 Vertical separation of powers

In order to create a counterweight to the center, Deng increased the power of local bureaucrats (Shirk 1993). Although the Chinese state is still *de iure* a unitary state, decentralization of authority has created a form of *de facto* federalism which is to be analyzed in this section along the five conditions of MPF which were introduced in Section 2.2.2.

Condition C1: In the course of the early reforms, the local governments achieved authority to supervise about 75% of state-owned enterprises (SOEs), to provide local goods (e.g., health care, education) and to attract foreign investment. In addition, the introduction of special economic zones (SEZ) and the delegation of reform policies increased the autonomy of provinces. Thus, C1 is fulfilled (Qian 1999a; Montinola et al. 1995).

Condition C2: During the Mao era, the central government received all fiscal revenues from the provinces and allocated the revenues to the various provinces (“eating from one big pot”). Deng introduced the fiscal contracting system (“eating from separate kitchens”). Under this system the local government, on the one hand, was obliged to transfer all revenues from central taxes to the central government. But on the other hand, revenue sharing quotas were negotiated so that the local government could gain from broadening the local tax base. In addition, extra-budgetary revenues could be completely retained by local governments which accounted for 16% of GDP in 1993. As extra-budgetary revenues are easier to hide from central officials, they reinforce the financial independence of local governments. Thus, C2 is also fulfilled.³⁰

Condition C3 was only partly fulfilled as many provinces used their increased autonomy to erect trade barriers. Although the revenue-sharing models imposed relatively hard budget constraints (Condition C4) on the local levels, the decentralization of banking services undermined these constraints as local governments were given significant influence on credit allocation (Montinola et al. 1995). In addition, decentralization proved to be durable (Condition C5) during the transition process. This is illustrated by the following example: In the aftermath of the Tiananmen quashing the conservatives were at the peak of their power and Chen Yun urged his protégé Li Peng to reduce the speed of reform and recentralize fiscal and investment decision powers granted to the provinces. But Li Peng, who hoped to succeed Deng Xiaoping in office, recoiled.³¹ In essence, all conditions of MPF are at least partially fulfilled. This demonstrates that federalism constitutes an effective limit to the Chinese central government. The pivotal influence of decentralization on the economy will be discussed below. Apart from MPF, Chinese-style, further institutional limits on the central government have played important roles.

³⁰ For a more detailed elaboration on these aspects see Jin, Qian, and Weingast (2004) and Montinola, Qian, and Weingast (1995).

³¹ Firstly, recentralization would have been too costly for the central government as the government expenditures for social safety would have increased, see Montinola, Qian and Weingast (1995), p. 68. Secondly, many provinces had invested their wealth into human capital and infrastructure so that it was difficult to seize. Thirdly, local cadre preferred staying in the provinces over being promoted to higher levels of the career ladder as autonomy and financial benefits were highest at the lowest level. Thus, local cadre had strong incentives to defend their autonomy. Finally, most Chinese people had profited from reform which created a strong limit on reform reversal, see Shirk (1993), pp. 191-92.

3.2.4 Rule of law, civil society, anonymous banking, and WTO accession

Since the anarchistic late-Mao era the rule of law has been gradually reinforced, particularly in the second phase of reforms. In 1982, the rule of law was formally set up in the constitution guaranteeing that everybody is equal before the law. Between 1986 and 1999, the number of legal cases more than tripled³² which shows that people and businesses were increasingly making use of the judicial system. But despite this progress, the rule of law has not been effectively realized.³³ Law enforcement is difficult because judicial decisions are not necessarily binding for state agencies or in particular Chinese regions (Saich 2001). The nomenklatura system allows the CCP to appoint judges which undercuts the independence of the judicial system. Judges and lawyers are poorly trained, corruption is rampant, administrative laws are weak and laws and regulations are not coordinated between lower and higher levels of government (Peerenboom 2002).

However, the rule of law is invigorated by China's WTO accession in 2001 because it limits the power of the CCP due to the commitment to international institutions, norms and laws.³⁴ Furthermore, the opening-up of the banking sector reduced the influence of the state-owned banks on the credit allocation, and the reduction of tariffs deprives the CCP of a powerful tool to protect domestic industries.³⁵ Thus, the credibility of the Chinese government towards investors has been considerably enhanced.

Before WTO accession and in the absence of the rule of law, the Chinese government was limited through a reduction of information (*information decentralization*) accessible to state agencies. To a large extent, information decentralization in China was achieved by *anonymous banking* which refers to cash transactions (which cannot be traced by the state) and anonymous banking deposits. As the state could not tax each particular person individually, it had to resort to a flat tax rate on bank deposits. Both the poor and the rich were taxed equally. Thus, there was an upper bound on the tax rate as the state had to leave some means for basic consumption of the poor in order to avoid severe protest. In essence, the government's ability to confiscate wealth was limited by the transitional institution of anonymous banking (Bai et al. 1999).

In many countries, a free press constitutes a strong limit of the state as citizens are neutrally informed on the behavior of the political leaders. In China, the state does not allow any limits with respect to neutral information of its citizens. Traditional as well as new media (e.g., the internet) are still controlled by the CCP.³⁶ But all media control cannot completely suppress the development of non-governmental organizations (NGOs)³⁷ and a gradual emergence of a civil society (which is, though, still very weak)

³² See Asian Development Bank (2002b), p. 42; in addition, the number of successful litigations against government increased, see Peerenboom (2002), p. 7.

³³ See Asian Development Bank (2002b), p. 41.

³⁴ See Bachmann (2003), pp. 119-120; already in May 1980 China had joined the IMF and the World Bank. But although China accepted advice from these organizations, authorities did not agree to any conditionality tied to international debt relief, see Nolan (1995), p. 184.

³⁵ For a summary of major effects of the WTO accession see Dorsey et al (2003), pp. 192-214.

³⁶ On the one hand, the CCP has direct control over state media. On the other hand, the CCP vigorously enforces its policy against non-state media agencies that publish subversive or unacceptable content for the CCP. Although this enforcement is rather selective most non-state media agencies conduct self censorship. The emergence of the internet did not strengthen the civil society, because the CCP was able to restrict independent information through harsh censorship, see Reporters sans frontiers (2004).

³⁷ NGOs only exist in non-political areas such as environmental protection, culture and religion; see Saich (2001), pp. 206-207.

(Zhang 2003). Particularly, the quashing of the Tiananmen protests, the increasing corruption and the growing inequality in China have disillusioned many Chinese people and officials (Hu and Lin 2003). But still, the Party has a strong grip on society, and limits on political power are still very weak.

In the absence of horizontal limits, decentralization implied a major institutional limit for the central government. In addition, the WTO accession, the exposure to world markets, and anonymous banking provided limits for the government. But the strength of the CCP and the fact that the general economic and political strategy is still developed by the Politburo in informal bargaining arenas portend the absence of strong institutional checks on the highest party organ.

3.3 The capacity of China's public administration

The bureaucratic system in China is organizationally grouped below the State Council. The highest ranked state organizations include the State Commissions which are responsible for the entire economy. Subordinate to the State Commissions are central ministries and at equal rank provinces.³⁸ With respect to governance, one of the integral powers of the CCP is the nomenklatura system which guarantees the appointment and control of administrative personnel (*cadre*). It is enforced by the Party's Central Discipline Inspection Commission (CDIC) and ensures the cadres' loyalty to the Party. Ultimately, informal relations determine the appointment of personnel and thus the functioning of the bureaucracy (Lieberthal 1992).

Under Mao, the administration was large and inefficient, but strong with respect to the implementation of policies of the CCP. The administration was used to intervene in all kinds of economic activities which led to a proliferation of public bureaux and agencies. Thus, the functions, working methods, incentives and qualifications as well as the organization of the public administration needed to be completely transformed in order to fulfill the demands of a market economy.

The first administrative reforms were initiated in 1982 when the number of ministries and commissions was reduced to 41 (Saich 2001). The objective of the second reform (1988-89) – transforming the omnipotent and interventionist administration into a function-limited one – was only partially achieved as the proliferation of departments and the interventionist activities could not be contained. Already in 1987, GS Zhao Ziyang announced an ambitious restructuring program for the public administration with the introduction of Western-style elements (merit-based promotion, competitive recruiting) and the partial separation of party and administration. But in the aftermath of the Tiananmen events the reform was blocked, dissident cadres were removed from office, and a Party career became more important as qualification for recruiting. Finally, in 1993 reformers and conservative forces agreed on a civil service reform which introduced competitive recruiting on the lower levels, high quality standards for public officials and limitation of tenure. But the party leadership, in fact, opposed the introduction of a politically neutral civil service and required public officials to adhere to Party ideology and authority. In 1998 commissions and other agencies were again cut

³⁸ This equal rank leads to the struggling between *tiao* and *kuai*. *Tiao* refers to the vertical authority of the central ministry over its administration. *Kuai* relates to the power of the provincial authorities on each horizontal level and thus emphasizes local autonomy. Lieberthal terms this relation "fragmented authoritarianism", see Lieberthal (1995), pp.169-170.

from 44 to 29 and the number of central bureaucrats was reduced by 50% (Heilmann 2002; Saich 2001).

In addition, salaries of public officials were increased to curb corruption. As the role of ideology diminished and the threat of ideological purges was reduced, the Politburo lost control over many party officials who used their positions for rent-seeking. A legacy of communism, informal relationships between business and influential cadre (who still occupy all major positions in China) determine the allocation of cheap credits, tax exemptions and use rights for property land. Fan and Grossman (2002) argue that selective toleration of corruption is a form of compensation for local officials in the absence of Western-style compensation that solves principal-agent problems.³⁹ But against the background of weakening corruption control in the preceding years, it rather appears that the mechanisms to keep corruption under control became less effective.⁴⁰ Reformers blame the absence of the rule of law and the lack of accountability of bureaucrats for the rampant corruption. In contrast, conservative forces regard the lacking discipline and the presumably negative Western influence as the primary cause. The deeper causes of corruption are only tackled in an experiment in Shenzhen where the accountability of public officials is increased by separating policy formulation, policy implementation and monitoring of public officials (Transparency International 2004). In 2003, Hu Jintao again announced to introduce competitive recruiting processes⁴¹, but it remains questionable to what degree these top-down initiatives will be implemented this time.

Concluding, the public administration has made progress on the way to a modern bureaucracy, but the close connection to the CCP undermines the cadres' credibility to stick to the rules. Recruitment for higher positions is still influenced by informal relations rather than open competition (low accountability). But in the end, the CCP has still sufficient power to enforce economic reforms.

3.4 China's economic institutions

Throughout the transition process, Chinese reforms followed a gradual approach, and they were frequently built on pragmatism.⁴² Most reform measures were tentative and only implemented after careful analysis of previous reform steps.⁴³ And yet, reforms were not random, but reflected the existing incentive structures generated by prevailing political and administrative institutions of the communist system (Shirk 1993). What follows focuses on the main institutional reforms along Eucken's constituent principles of a market economy.

³⁹ Local companies, which pay bribes, can best assess which local officials contribute most to local economic performance; see Fan and Grossmann (2002), pp. 200-203.

⁴⁰ See Saich (2001), pp. 302-5; in Xiamen large-scale smuggling of public officials involved approximately 80 billion Yuan; during the construction of the large dam at the Yangtze River 473 million Yuan were misappropriated and 425 million Yuan could not be found.

⁴¹ See Transparency International (2004), p. 178; in addition, monitoring of provincial officials is reinforced and sources of illegal revenues are to be erased (like administrative licensing for marriages, start-ups).

⁴² See Qian (1999b), p. 4; this pragmatism was described by Deng in the famous sentence: "It doesn't matter whether a cat is white or black so long as it catches mice."

⁴³ See Chow (2004), p. 140; Deng's phrase "groping for stones to cross the rivers" famously describes the tentative character of the reform process.

3.4.1 Private property rights

In China, a major pillar of Eucken's constituent principles was absent because private property rights were constitutionally not fully protected until March 2004.⁴⁴ Nevertheless, the private sector generated already 32% of total GDP in 2000.⁴⁵ Thus the question arises how the private sector could evolve and how the economy achieved substantial economic growth without property-rights protection.

Induced by the ideological shift of the CCP in 1978, peasants illegally experimented with the shift from collective to individual production and ownership. The emerging so-called household responsibility system (HRS) proved to be more effective than collective farming because transaction costs were lower. Due to substantial increases in output, the HRS was introduced in most Chinese provinces and officially legalized in 1981 (Lin 1987).

In the first period of reforms (1978-93), sustained economic growth was mostly generated by Township-Village Enterprises (TVEs), while genuine private companies played only an insignificant role.⁴⁶ In advanced market economies, local government ownership would be less efficient than private ownership due to the costs associated with interventions in the market mechanism. However, in the special Chinese institutional setting, various reasons explain why ownership by local governments dominated private ownership.

Local governments were capable of protecting TVEs against ideologically motivated anti-private-property programs⁴⁷, and it was easier for TVEs to receive bank credits.⁴⁸ Furthermore, local governments controlled the allocation of land, water, and electricity at the beginning of the reform process (Che 2002). As TVEs were governmentally owned, managers could be monitored and sanctioned by the local government, thus reducing principal-agent problems (Burawoy 1997). But a major precondition for the emergence and success of TVEs was decentralization which provided local governments with authority over local economic development and gave them the right to retain most of the local tax revenues.⁴⁹ But as the ideology against private property rights became less restrictive over time, the advantages of local government ownership were reduced. Consequently, local governments transformed

⁴⁴ In the March 2004 amendment to the Chinese Constitution, only lawful private property rights are secured whereas all state property is protected. This portends the still existing misgivings of the Party against private property rights; see *The Economist* (2004a).

⁴⁵ See Asian Development Bank (2003), p.4.

⁴⁶ Without SOE privatization the share of non-state enterprises rose from 22% in 1978 to 57% in 1993. In 1993 TVEs employed 52 million people; see Qian (1999a), p.11.

⁴⁷ Che and Qian (1998a) argue that local governments were less likely to be expropriated than private owners because local governments used TVE rents for improving the provision of local goods. Thus, the interests between central and local governments were better aligned than the interests between the central government and private owners.

⁴⁸ First, banks were exposed to less risk when lending to TVEs as the local government could bear some of the banks' risk due to cross-subsidization among its various TVEs. In addition, the fact that local governments protected the TVEs' property reduced default risk. Second, local governments capitalized on their personal relationships to state-owned bank managers, see Qian (1999a), p.13.

⁴⁹ Qian argues that the local government founded their own business rather than taxed private businesses as it was cheaper to extract rents from the own business. Following the same argument, the central government faced difficulties to take away proceeds from TVEs, see Qian (1999a), p.13; in addition, Krug and Hendrischke (2004) argue that a high amount of social capital might have facilitated the emergence of entrepreneurship in China in the absence of secure property rights.

more and more TVEs into individual shareholdings (Che 2002; Asian Development Bank 2003).

With the decision to create a so-called socialist market economy in 1993, the private sector was, for the first time, officially recognized as major pillar of the Chinese economy in 1997. But only in 2004, private property rights were defined as inviolable in an amendment to the Constitution. When the SOEs faced growing competitive pressures from TVEs and foreign companies during the period until 1993, incentives for managers improved, and managerial objectives shifted from plan fulfillment towards more profitability. Nevertheless, numerous SOEs incurred losses and excess employment was pervasive in 1995.⁵⁰ The ensuing SOE reform followed the principle “seize the large and release the small” and included the privatization of small- and medium-sized SOEs, mass lay-offs at the city level and mergers, joint-ventures and corporatizations of the large SOEs.

Local governments had incentives to privatize small- and medium-sized SOEs due to the hardening of budget constraints and the increasing competition from private and foreign companies in China.⁵¹ In general, the loss-making SOEs were sold first as public officials did not have advantages from keeping the firms under their control (Laffont and Qian 1999). Once the majority of the industry was privately-owned, the SOEs became even more inefficient and loss-making (Shirk 1993). The privatization policy was quite successful as all parties involved gained from privatization, although public officials used the privatization process for massive personal gain.⁵²

With respect to the larger SOEs, the central government aimed to minimize social disruption and is still reluctant towards privatization and the introduction of hard budget constraints (Heytens 2003). Nevertheless, drastic employee-cuts were carried out in the late 1990s. In the absence of a working social welfare system, the government managed to credibly pre-commit to compensate the workers for the loss of their jobs so that transaction costs in form of social instability could be reduced.⁵³ It is estimated that by 2000, SOE losses were reduced and half of the redundancies were eliminated. But financials are still weak, transparency is low and hard budget constraints absent (Heytens 2003). Summing up, through decentralization, local governments were induced to create viable solutions in the absence of private property rights. Since 1993, private property rights have become better protected, but SOEs still endanger the macroeconomic environment. As already emphasized, one key determinant of the privatization success was intensified economic competition in China which is to be analyzed in the following section.

⁵⁰ See Asian Development Bank (2003), p. 11; in 1994, still about 75m employees worked in approximately 300,000 SOEs.

⁵¹ See Cao, Qian and Weingast (1999), p. 121. Due to high debt-to-asset ratios, the price for the equity value of the small- and medium-sized SOEs was quite low so that there did not exist a wealth constraint in the sale process. Small- and medium-sized SOEs were mostly transformed into private-limited companies, stock co-operatives and sold to a private foreign or domestic company.

⁵² See Heilmann (2000) and Heytens (2003), p. 132. Private investors benefited from the increasing value of their shares in the thriving businesses and the local government was relieved from loss-making enterprises; see Cao, Qian and Weingast (1999), p. 112.

⁵³ Two components mitigate social problems. *zaijiuye gongcheng* workers are compensated ex post by helping them to find a new job and *Xiagang* workers are compensated ex ante by paying a subsistence salary, See Cao, Qian and Weingast (1999), p. 113.

3.4.2 Competition policy

Since 1979 the central government's power over the industry sector gradually decreased, and TVEs were founded. Since the mid 1990s prices had been almost completely liberalized which significantly spurred competition. Tariffs were reduced from approximately 50% in the beginning of the 1980s to about 15% in 2000 and will further decrease due to WTO accession (Tseng and Zebregs 2002). In addition, the economy was opened up in the 1980s by the introduction of SEZs, mostly in the coastal areas near Hong Kong, which granted preferential tax and tariff treatment to foreign investors.⁵⁴ Due to MPF, many provinces and counties had incentives to attract FDI and competed against each other by building infrastructure and granting special tax treatment. Due to FDI a large amount of technological knowledge was transferred to China. Except from the SEZs, most foreign companies could only enter the Chinese market through 50:50 joint ventures so that management and technological skills quickly diffused to the Chinese joint-venture partners.⁵⁵ With the increase of per capita income, FDI was increasingly targeted at the domestic market away from initial export-oriented FDI so that domestic competition increased by the early 1990s.⁵⁶ With WTO accession foreign competition will further increase.

In addition, the "Countering Unfair Competition Law" was established in 1993 with the objective to protect fair competition.⁵⁷ Nevertheless, regional governments erected trade barriers to protect their local businesses (Qian 1999a). These and other violations of the law are in many cases not penalized because the objective of regional development is often regarded as superior to the protection of competition. A complete anti-monopoly law is still missing but – as it is part of the commitment to the WTO – it is expected that the law will be passed in the near future.⁵⁸ But according to the business climate survey of the ADB, some 79% of foreign companies reported that they still had to cope with market restrictions.⁵⁹ In essence, particularly the opening of the market to foreign companies spurred competition in China.

3.4.3 Monetary stability

As Chinese authorities relied on a gradual liberalization policy, the prices of the majority of products were only fully liberalized by the mid-1990s. Under the dual-track approach prices were first only freed for above-quota production, while at the same time all prices and quotas set in the economic plan were maintained and only slowly

⁵⁴ Four SEZs were established in 1980, a fifth in 1988. In addition, in 1984 fourteen coastal cities were opened to FDI, see Tseng and Zebregs (2002), p. 14.

⁵⁵ See Tseng and Zebregs (2002), p. 4; in 1999, 88% of FDI entered the eastern provinces, only 29% the central ones. Furthermore, the condition that foreign companies had to use local suppliers enhanced the quality of domestic products. Tseng and Zebregs show that FDI has increased total factor productivity by 2.5 annual percentages points since the 1990s, see Tseng and Zebregs (2002), p. 19.

⁵⁶ See Tseng and Zebregs (2002), pp. 9-10 and pp. 13-14; the government still channels FDI to specific industrial sectors and regions and prohibits FDI that introduce too much competition to SOEs.

⁵⁷ See OECD (2004); the law deals with traditional issues of anti-competitive laws (such as forgery) and stipulates that governments are not allowed to restrict market entry and erect trade barriers.

⁵⁸ See China Daily (2004a).

⁵⁹ See Asian Development Bank (2003), pp. 32-33; market entry is partly restricted as registration and licensing procedures are abused by local officials to extract rents and protect local companies.

phased out at a later stage.⁶⁰ Lau et al. (1997, 2001) convincingly argued that the dual-track approach did not create losers and in fact enhanced efficiency.⁶¹ The partial liberalization of prices under the market track created incentives for economic actors to increase production.⁶²

Since liberalization was gradually introduced, inflation did not soar like in Russia.⁶³ Thus, private savings were not destroyed, but could be channeled to investment activities in new companies and used for the restructuring of SOEs (Walder 1996). With respect to the foreign exchange market, China also followed a dual-track approach with a planned exchange rate and a market rate (which made up already 80% in 1994). In 1996, full current account convertibility was introduced (Qian 1999a). But capital account convertibility is still restricted today in order to protect the weak Chinese financial system.⁶⁴ In the first half of 2004, inflationary tendencies gained momentum as both foreign investments and domestic demand increased. Nevertheless, the government has managed to keep inflation low while at the same time experiencing high growth rates.

Fiscal stability was partly achieved by the promotion of the export industry which guaranteed foreign exchange inflows to China. The high household savings rate enabled the government to pay for SOE losses (which were estimated to be about 8% of Gross National Product by 1991) and thus helped to maintain a fiscal balance.⁶⁵ By June 2004, foreign exchange reserves amounted to US\$ 470 billion and the fiscal balance was -2.6% of GDP in 2003.⁶⁶

In 1983, the monobank system was transformed into a two-tier banking system (central and commercial banks) and in 1985, the Chinese central bank, the People's Bank of China (PBC), was endowed with central bank functions.⁶⁷ But it did not have sufficient means to curb monetary supply.⁶⁸ In the course of the restructuring of the banking system in 1994, three types of financial institutions emerged: commercial, policy and cooperative banks. The four largest commercial banks remained under government control, but were granted greater autonomy. In addition, the policy banks were used for channeling cheap credits to inefficient SOEs in order to avoid large scale lay-offs. After the PBC was directly subordinated to the State Council in 1995, the power of the provinces over local central bank branches was cut off (Lardy 1998). In 1998, the central

⁶⁰ See Qian (1999a), p. 17; under the old track, economic agents could still purchase and sell products at state-administered prices. Under the market track, economic agents were allowed to buy additional inputs and sell its above-quota production at market prices, see Chow (2004), p. 133.

⁶¹ Usual conditions include profit maximization and perfect competition. Those who choose to participate in the market track will profit from market transactions and those who stick to the status-quo-track are compensated for the partial liberalization in form of the guarantee of existing rents.

⁶² For example, the steel production under the planned track remained stable but its share of total steel production decreased from 52% in 1981 to 30% in 1990, see Qian (1999a), p. 19.

⁶³ Inflation only slowly rose after 1984 and reached its peak in 1988 with an inflation rate of 18.5%, Garnaut and Ma (2001), p. 89; but inflation could be reduced and only in 1993-1994 heavy investments led to high inflation. The burst of the investment bubble in 1995 left a hangover of excess capacity which resulted in deflationary tendencies which persisted until 2003, see The Economist (2004b).

⁶⁴ See Li (2004), p. 91; nevertheless, foreign companies are allowed to pursue FDI in China.

⁶⁵ See Sachs and Woo (1994), p. 129; the government could increase the money supply which the households willingly held.

⁶⁶ See Bank of Finland – Institute for Economics in Transition (2004).

⁶⁷ An overview on the early banking reform is given in Naughton (1995), pp. 255-59.

⁶⁸ In order to bring the 1989 inflation down, central and local governments jointly reduced investments by use of the nomenklatura system and the credit plan, see Yusuf (1994), p. 114.

credit plan was abolished and new methods for monetary policy were introduced (e.g., treasury bonds) (Heilmann 2000). In 2003, the supervisory function for the banking sector was shifted from the PBC to the newly established China Banking Regulatory Commission so that the PBC can now concentrate on monetary policy only and the regulation of the banking sector is improved. But the PBC is still not completely independent as major monetary and supervisory decisions are still to be approved by the State Council (Asian Development Bank 2006; Karacadag 2003).

Despite various banking reforms, the financial sector is still the Achilles' heel of China's economy. The banks fail to effectively allocate financial resources to profitable projects, and thus bad loans are estimated to amount to almost 30% of total outstanding loans in 2002. The recapitalization of two major Chinese state-owned banks indicates that the government is starting a new attempt to reform the banking sector.⁶⁹ But as long as the politically motivated soft budget constraints for some favored industries are not restrained, recapitalization programs will only cure the symptoms.⁷⁰ The Chinese government still hinders foreign banks to enter, and it is still not clear whether authorities will open the financial sector to foreign investment by 2007 as agreed in the course of WTO accession. But a restructuring of the banking sector is pressing, particularly against the background of a comparatively small domestic capital market. Karacadag (2003) regards privatization, the strengthening of accounting and disclosure standards as well as stricter central bank regulation and prudential enforcement as necessary steps for the next reform efforts.

In essence, as the central bank is still not completely independent, bad loan portfolios are immense and investment as well as consumption in China is strong, monetary stability is not ensured. Nevertheless, due to immense foreign reserves there does not seem to be the danger of a collapse of the financial system.

3.4.4 Hard budget constraints

In 1986, the government promulgated a bankruptcy law which was rarely applied (Bramall 2000). Nevertheless, during the first period of reforms, local governments faced quasi hard budget constraints. Due to the policy of "eating in separate kitchens", local governments had to pay fixed amounts to the center and received taxes contingent on the economic performance of local companies. Thus, it was more rewarding to propel local economic growth than bargaining for resources from the central government (Burawoy 1997). In the first period of reforms, TVEs had much harder budget constraints than SOEs.⁷¹ Qian and Che (1998b) argue that governments were more inclined to lend to SOEs as the central government could internalize monitoring costs. The central government controlled both the state banks and the SOEs. Thus, if the SOEs diverted funds the first time, the state banks would also provide refinancing means as the central government received all benefits from refinancing. The threat not to provide refinancing was not credible ex-ante. If a TVE diverted funds the first time,

⁶⁹ See The Economist (2004b); in January 2004, the People's Bank of China disposed over approximately US\$ 400 billion of foreign exchange reserves.

⁷⁰ See The Economist (2004b); since 1998 the government has spent approximately US\$ 200 billion on recapitalization of banks.

⁷¹ See Qian (1999a); the SOEs' share in total outstanding non-agricultural loans was 86% in contrast to 8% for TVEs.

the state banks had to spend extra funds on motivating the local government to monitor the TVEs. Due to lower returns the banks would not refinance these companies. As the managers of the TVEs were aware of this ex-ante, they had incentives to not divert funds in the first round. The existence of harder budget constraints for TVEs has been one reason for their strong economic growth.

In 1994, hard budget constraints for local governments were reinforced by three measures: first, the central government launched a major tax reform⁷²; secondly, in 1995 a new Budget Law was passed which obliged subnational governments to present balanced budgets⁷³; and thirdly, the reform of the central bank reduced the power of local governments to influence credit allocation. Although competition between the four major state banks (since 1994) reduced credits granted to SOEs, their budget constraints remained weak (Heytens 2003). Finally, a draft for a new bankruptcy law was presented at the 10th NPC Standing Committee meeting in June 2004. The law is to be applied to all eight million Chinese companies with the exception of 2,000 large SOEs (China Daily 2004b). The drafting of the law started in 1994, but the government feared additional mass lay-offs of workers which could create social unrest. However, with progress in building a social safety net the lay-offs can be mitigated by the time the law will finally be adopted.

3.4.5 Steadiness of economic policymaking

During the first phase of transition, economic policies were not very predictable and stable due to the cleavages within the CCP. After the Tiananmen incidents, it was unclear to what extent the CCP would follow the reform path. Only after Deng had made his Southern Tour in 1992 and the CCP had decided to transform China into a socialist market economy in 1993, steadiness in economic policymaking was increased. This decision was a major factor for the strong increase in FDI since 1992. Since then the government has shown further commitment to reforms by acceding the WTO, which again propelled FDI. The smooth succession from Jiang Zemin to Hu Jintao is not finished yet, and Hu Jintao will probably not pursue any major changes in economic policies until he will have consolidated his power (Bachman 2003). Nevertheless, there are no signs indicating that economic reform would be slowed down. The reforms undertaken in 2003 and 2004 rather reinforced the path towards establishing a rule-based market economy.

The foregoing analysis has revealed that almost all standard political as well as economic institutions were absent in the first period of reforms (such as horizontal separation of powers, private property rights, free prices, and competition laws). However, viable but unorthodox solutions were found to the problems of the institutional weakness of the transitional environment. Due to fiscal decentralization, local governments faced to a certain extent hard budget constraints. At the same time,

⁷² See Cao, Qian and Weingast (1999), p. 116; it included the establishment of a national tax bureau and the introduction of an indirect value-added tax (VAT) which was to be collected by the central government (local governments received 25% of the VAT revenues). With the adoption of the new reform, local governments could hardly extract tax revenues at the expense of the central government which hardened their budget constraints.

⁷³ In addition, the issuing of bonds by sub-national governments was restricted and strictly controlled by a newly established State Auditing Agency. See Cao, Qian and Weingast (1999), p. 117.

they had incentives to create and support businesses and to compete with other local governments for investment. In this way, a surrogate for private property rights was established. The dual-track liberalization slowly introduced free prices which were to a large extent established by mid-1995. Thus, in the absence of high inflation Chinese people could accumulate savings which were used for financing the losses of SOEs and the investment in new enterprises. In the second phase of transition, institutional reforms were more profound and tackled the underlying problems of the Chinese economy. The SOEs were partly privatized, the banking sector restructured, bankruptcy laws reinforced and private property rights legalized. But still, the banking sector is fragile, hard budget constraints for SOEs not fully established, and competition restricted so that further reforms are required.

4. Conclusion urope

The analysis of the Chinese institutional matrix pursued the objective to investigate to what extent China has established a market-enhancing governance structure (MEGS). During the first period of reforms, the state developed and maintained its capacity to formulate, implement, and enforce policy and institutional reforms despite an increase in corruption and intra-party cleavages. In the course of time, although being the ultimate power in Chinese politics, the central government managed to credibly limit its own power through decentralization and anonymous banking. In this context, the incentive compatibility of policymakers at the national and the subnational levels has been of utmost importance. In the absence of the rule of law and private property rights, economic growth could be propelled via special transitional institutions which proved viable in this particular environment. These institutions were not influenced by theoretical models, but relied rather on innovation and experimentation which was a major trait of Chinese early reforms (Qian 1999a). In the second period of transition, the gap to a MEGS was further narrowed. The political process was more institutionalized, although major decisions within the CCP were still made in informal bargaining arenas and the nomenklatura system remained in place. But particularly the accession to the WTO revealed the commitment of the Chinese government to invigorate the rule of law as an additional limiting factor to its power. Moving closer to a rule-based economy, economic institutions have been more consistently enforced during the second period (particularly through the privatization of SOEs and restructuring of the financial sector).

Summing up, it can be recognized that China gradually improved the quality of its governance structure, which contributed to the unfolding of market forces more effectively than governance structures in other transition economies or less developed countries. Market-enhancing governance, Chinese-style, has neither followed a straightforward theoretical imperative nor has it yielded clear-cut lessons for other countries at the same stage of economic development. The Chinese case reinforces the view that institutions and governance matter, but that a best-practice approach, which fits all countries, does not exist. Basic principles such as credibility, predictability, and transparency, in fact, play a key role. The better a country's institutional matrix performs according to these principles the more effective is its governance structure and the easier it is for policymakers to gain legitimacy and enhance their credibility.

Notably, the Chinese strategy to rely on transitional institutions and to transform the economy gradually could work because this approach managed to balance the need to foster economic growth with the necessity to address effectively social equity

concerns (through providing access to education, sanitation, and health care) and, particularly important, to meet the interests of those who have been in power. Thereby, this strategy emphatically fostered the incentive compatibility of political and economic actors with respect to market-oriented transition and eventually enhanced the credibility of political authorities.

Moreover, the Chinese experiences indicate that governance quality is a relative as well as a dynamic factor: It is relative because the quality needs to be assessed with respect to the country's stage of development and regarding the governance quality of other economies which may compete for mobile factors of production. It is dynamic because different stages of economic development, varying international environments, and changing political side conditions may render hitherto effective governance structures obsolete and demand new institutional arrangements which are suitable to cope with these new challenges to policymaking.

While the Chinese governance structure has performed comparatively well according to key governance dimensions, the transitional institutions, which constituted this governance structure, can hardly serve as the foundation for future development. Therefore, the way to sustainably improve the market-enhancing characteristics of the Chinese governance structure in a globalizing world is complicated and demanding. Particularly, the lacking accountability of the central government, the still weak rule of law, the vulnerable financial system, the deficits of corporate governance structures, and the restructuring of the SOEs need to be tackled in order to establish a sustainable, development-promoting MEGS in the future.

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