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BOOK REVIEW ROUNDTABLE

Nicholas R. Lardy's

Markets over Mao: The Rise of Private Business in China

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Nicholas R. Lardy

The State of China's Economic Miracle

Kellee S. Tsai

What are the sources of China's breathtaking economic growth since the late 1970s? The answer is encapsulated in the title of Nicholas Lardy's most recent book, *Markets over Mao: The Rise of Private Business in China*. It's the private sector. In 1978, state-owned enterprises generated three quarters of China's industrial output. Today they account for only one quarter. Besides displacing state firms in terms of industrial output, private firms now produce nearly 90% of the country's exports, are far more profitable than state firms, and employ a growing share of the urban workforce. *Markets over Mao* methodically combs through over three decades of government statistics to demonstrate, with empirical confidence, the remarkable expansion of China's private economy.

Lardy provides a valuable service to those daunted by how to triangulate among internally inconsistent sets of official Chinese data, with their shifting categories of firm ownership and reporting practices. The third chapter of *Markets over Mao* is especially instructive in delineating the seven major types of firms, including explanations of the five subcategories of private firms. Of particular interest, Lardy alerts us to enterprise lending data released by the People's Bank of China starting in 2011, which identifies the majority or dominant ownership stakes in limited liability companies and shareholding limited companies. Some are primarily owned by state entities, while private shareholders have majority or dominant stakes in others. Yet private shareholder-dominant companies are not typically included in calculating the size, economic contributions, and financial indicators of the private sector. Hence, a recurring cautionary message in *Markets over Mao* is that relying on official registration status in statistical yearbooks underestimates the true scope of China's private economy.

Markets over Mao goes beyond serving as a statistical roadmap for number crunchers, however. The book boldly argues that China should not be regarded as state capitalist. This claim rests on three main observations. First, the private sector is growing and outstrips state firms in multiple performance indicators, including return on assets. Second, China's

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private sector is not as credit-constrained as most people think. Third, and relatedly, the bulk of the government's 2008–9 stimulus funds were not disproportionately invested in the state sector. The first observation is uncontroversial. Economists and other dedicated observers of China's political economy agree that the private sector is more dynamic and profitable than the state sector, even as state-owned giants grab news headlines. The second and third claims, however, warrant further reflection.

Readers may be surprised by the book's argument that most accounts of China's private sector exaggerate its financing challenges. Lardy points out that the preponderance of investment in reform-era China has been financed by retained earnings rather than by bank credit or equity markets. During the 1990s, about 40% to 50% of investment in nonfinancial corporations came from retained earnings; and the ratio reached an average of 71% during 2002–8. The private sector has been particularly reliant on retained earnings due to its higher rates of productivity and "more limited access to bank credit" (p. 97). However, Lardy quickly discounts the latter issue by contending that the private sector receives more bank loans than normally recognized—and actually received a growing share of bank loans during the stimulus years. He estimates that in 2012, 44% of all loans outstanding went to the private sector, an increase from 35% in 2009. As detailed in "Appendix A: Alternative Measures of Private Sector Credit," this calculation includes not only loans to private firms and individual businesses but also business loans to rural households, consumption loans to households (including mortgages), and firms where the dominant shareholder is private. Including these additional loans shows that between 2010 and 2012 private firms accounted for 52% of new lending, whereas state firms received only 32% (p. 104).[1] *Markets over Mao* states decisively, "Chinese private firms now enjoy better access to credit than in any previous period in the reform era" (p. 108).

Why, then, does the conventional wisdom persist that private businesses in China face a structural financing gap relative to state firms? Lardy notes that observers typically (myopically) focus on the percentage of short-term loans going to officially registered private and individual businesses.[2] As of

1 Another empirical study finds, however, that prior to the global financial crisis, China's state firms had lower levels of leverage than private firms, but following the crisis, state firms became much more highly leveraged than private ones. Mali Chivakul and W. Raphael Lam, "Assessing China's Corporate Sector Vulnerabilities," International Monetary Fund, IMF Working Paper, no. 15/72, March 2015, 10.

2 See, for example, Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Ithaca: Cornell University Press, 2002).

2009, private firms received only 1.78% of total short-term loans (p. 158, Table A.1). Another basic reason is because private firms—especially the small and medium-sized enterprises (SME) that constitute 97% of registered businesses—indeed face barriers in accessing credit from state banks. The reasons for these credit constraints are well-known: collateral requirements, smaller loan sizes, risk aversion by state-employed credit officers, and prioritization of lending to state firms in key industries. Throughout the reform era, downstream private firms have thus depended primarily on retained earnings and a variety of informal financing mechanisms. A 2012 survey of SMEs in fifteen provinces, for example, found that 57.5% of respondents had participated in informal credit markets.[3] Moreover, in China's biannual surveys of private entrepreneurs, "access to credit" remains a leading self-reported constraint facing private-sector development.[4] Indeed, after presenting novel indicators of increased bank lending to private firms, Lardy concedes that "it is still accurate to say that relative to their contribution to GDP state firms have greater access to bank credit than private firms" (p. 109).

The foregoing observations raise the broader analytic question of how to characterize the nature of China's contemporary political economy. Lardy is adamant that state capitalism is not an appropriate descriptor. China has made a transition to market capitalism, Lardy contends, because the state no longer dominates the allocation of resources in product markets. Arguably, however, the "market economy" label is too broad to capture important features that distinguish China from other market economies. The "varieties of capitalism" framework, for example, identifies major institutional differences between liberal market economies (e.g., the United States) and command market economies (e.g., Germany) in industrial relations, education and training, corporate finance, inter-firm relations, and corporate governance.[5] Varieties of capitalism within Asia have also been recognized, ranging from the postwar developmental states of Japan, South Korea, and Taiwan, which pursued industrial policy and strategic allocation of credit, to the entrepôt city-states of Hong Kong and Singapore that have flourished as regional centers for trade and finance. All are

3 Jianjun Li and Fengyun Hu, "Zhongguo zhongxiao qiye jinrong jiegou rongzi chengben yu xinzi xindai shichang fazhan" [Financing Structure and Cost of China's Small and Medium-Sized Enterprises and Development of the Shadow Credit Market], *Hongguan jingji yanjiu* 5 (2013): 7–11.

4 *All-China Federation of Industry and Commerce, Private Economy Yearbook* (Beijing: China Zhi Gong Press, various years since 1992).

5 Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001).

regarded as market economies, but their de facto one-party states played important strategic and variegated roles during their high-growth decades.

The role of the state in China's reform-era growth shares some similarities with East Asian varieties of capitalism but also diverges in key aspects. On the one hand, China has been quite open to foreign direct investment—as were Singapore and Hong Kong but not Japan, South Korea, and Taiwan during their high-growth periods. On the other hand, *Markets over Mao* acknowledges that a number of state-defined strategic sectors are closed to both private and foreign investment. These include the military, telecommunications, power generation and distribution, petroleum and petrochemicals, civil aviation, and shipping. Meanwhile, the 2010 Strategic Emerging Industries initiative selected seven next-generation technologies and products for preferential policies (e.g., tax rebates and financial incentives). Such targeted policy measures are well-known to students of East Asian political economy.

Yet the scope of state intervention in China goes beyond familiar levers of the East Asian developmental state. Senior leadership and managers of state-held firms are appointed by the Organization Department of the Chinese Communist Party (CCP). The party-state "completely dominates" the financial sector, including banking, insurance, securities, and asset management (p. 20). Furthermore, a number of successful "private firms" originated out of close ties to the party-state (e.g., Lenovo and the Chinese Academy of Sciences, Huawei and the People's Liberation Army). No one seriously contests that private firms are more profitable than state firms, or that market forces are vibrant in retail, exports, and nonstrategic industrial sectors. But other institutional characteristics suggest that China's party-state plays a more significant role in the economy than would be expected in an average Organisation for Economic Co-operation and Development (OECD) market economy. China's market is being mediated, even thwarted, by a host of competing political priorities—namely, social stability and the continuation of CCP rule.

In contesting the depiction of China as state capitalist, *Markets over Mao* draws on various popular and political sources that use the term in a critical manner. As evidence, the book cites declining state profits, the ineffectiveness of industrial policy, and increased bank lending to the private sector. However, state capitalism is not a theory about economic performance. In studies of comparative capitalism, state capitalism is an analytical category that describes the hybrid organization of an economy by delineating the political motives, institutional scope, and intended effects of state intervention. Economic outcomes may vary. Ultimately, *Markets over Mao* is more convincing in making the case for how state capitalism is constraining growth opportunities in China than in dispelling the empirical existence of state capitalism itself.

In the end, Lardy's sanguine assessment of China's Third Plenum reform agenda implies that China is gradually making a teleological transition toward a liberal market economy. He acknowledges that implementing those reforms will entail "significant transition costs, and will be opposed by the interest groups that have benefited disproportionately from the imbalanced growth of the past" (p. 153). Political barriers indeed exist, but they extend beyond vested interests and corrupt officials. The party-state itself is reluctant to relinquish control over strategic sectors. Regime durability and regional leadership may be more important to China's rulers than return on assets. With $3.7 trillion in foreign exchange reserves, China possesses the resources for "evergreening" unprofitable state firms in the interest of national economic security, with plenty to spare for initiatives such as the Silk Road Fund and the Asian Infrastructure Investment Bank. China's state sector may be shrinking, but the party-state's aspirations for what remains is not.

Distortions in the Balance Sheet Matter to China's Growth

Michael Pettis

In his most recent book, *Markets over Mao: The Rise of Private Business in China*, Nicholas Lardy carefully compiles and analyzes an enormous amount of data to support his claim that China's private sector, and not the state, has become by far the most important source of recent growth in Chinese productivity and employment. Between 2010 and 2012, Lardy argues, private sector firms produced between two-thirds and three-quarters of China's GDP, far more than the state sector, even as they received a disproportionately low share of resources (pp. 139–41).

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While reviewers have praised this important book mainly for refuting conventional wisdom on the central role of China's state capitalism, I think they overstate the novelty of Lardy's argument, and in doing so perhaps understate the real value of the book. It is widely known that in spite of limited access to capital, China's small and medium-sized enterprises are highly productive, often extraordinarily so. What is more, worries about the sustainability of the growth in Chinese debt are driven precisely by concerns that the systematic tendency of the public sector to misuse resources—capital, most importantly—has driven down profitability even as debt has risen steeply. That China's private sector produces more with less is not a secret.

Rather than reshape our understanding of the relative contribution of China's market and nonmarket sectors, Lardy's real contribution is to document carefully the ways in which the main sources of growth in Chinese productivity and employment have evolved from the centralized decision-making process that was set up more than twenty years ago to provide much-needed infrastructure and manufacturing capacity to one today that includes a highly productive, market-oriented private sector. By describing and explaining this extraordinarily complex and poorly understood story, Lardy also suggests the key reforms on which President Xi Jinping and his administration must focus.

Economists who are confident that China will maintain rapid growth while successfully rebalancing its economy—including Lardy himself, who argued in an April 30 presentation that "China could grow at roughly 8% a year for another 5 or 10 years," against consensus forecasts of 6%–7%[1]—will agree with Lardy that if China's market sector managed to grow as rapidly as it did in spite of limited access to capital and other resources, simply by reversing these constraints Beijing can ensure rapid growth as China's economy rebalances.

But here is the paradox. Those who expect growth to slow significantly, as I do, find Lardy's work no less useful than do his peers in optimism. It is a testament to the objectivity of Lardy's research that we too will praise the quality of his data and agree with much of his interpretation. We will argue, however, that it is precisely because Lardy correctly identifies the reforms required to maintain high growth that we expect growth rates to drop sharply.

Economists notoriously ignore history, but history nonetheless suggests that the many attempts among developing countries to impose similar

1 Nicholas Lardy, "Market versus State" (presentation at Chatham House, April 30, 2015, London).

reforms have always proved far more difficult than anyone expected. Because redirecting the flow of resources necessarily undermines institutions that have long controlled access to these resources, in China as elsewhere, these institutions prevent reforms from being implemented quickly enough to avoid either much slower growth or a risky increase in the debt burden. Premier Wen Jiabao promised in 2007, after all, to rebalance the economy with similar reforms, and yet China's imbalances deteriorated rapidly during the next five years just as Beijing began denouncing the nefarious role of "vested interests."

There is a second set of constraints, however, that limit the positive impact of reform in ways I believe Lardy, and most economists, tend systematically to underestimate. While *Markets over Mao* carefully describes the operations of the Chinese economy—or, put differently, how China's "assets" are managed—it largely ignores how China's liability structure will affect growth.

This point is often contested, mainly because it is so poorly understood. Most economists assume that growth is primarily a function of how productively a country's assets and operations are managed. While they readily acknowledge that "too much" debt is bad for an economy, they still assume implicitly that debt is functionally irrelevant in determining the pace of growth. Ask how much debt is too much, and these economists usually respond with debt ratios. Ask how and why too much debt can reduce growth, and their responses either are mostly unintelligible or consist of circular references to "confidence" or the risk of debt crises.

But debt matters enormously in two important ways that are largely missing in the debate about China. First, the structure of the balance sheet can exacerbate volatility. Second, it can create financial distress costs. In either case, economic performance can no longer be evaluated mainly as a function of how a country's assets are managed.

To take the former, my book *The Volatility Machine* (2001) showed how rapidly growing developing countries like China create "inverted" balance sheets in which economic performance is systematically exacerbated by highly pro-cyclical financial system mechanisms. As the economy expands, these mechanisms reinforce growth, often to the point of generating growth "miracles." Because few analysts understand these pro-cyclical mechanisms, their initial surprise at the vigor of economic expansion eventually turns into rising estimates of the economy's potential growth rate.

Distortions in the credit market, and especially in interest rates, usually create imbalances in the way growth is distributed, and the more growth depends on pro-cyclical credit expansion, the more it is unbalanced. Albert Hirschman often reminded us that all growth is unbalanced, and that these imbalances eventually reverse. But as the optimism of the 1950s and 1960s among development economists was eroded by events, so too was his casual attitude toward rebalancing. By the 1980s Hirschman began to worry that a successful rebalancing was the most difficult constraint to long-term growth.

Rebalancing is often harder than expected, in other words, not just because of opposition by vested interests, but more importantly because highly inverted balance sheets cause policymakers to overestimate potential growth during the miracle years. But when growth during the rebalancing phase contracts more than expected, the same balance sheet inversion that exacerbated the expansion phase will also exacerbate the slowdown, especially as declining credit quality reinforces, and is reinforced by, slower growth.

It is easy to find typical pro-cyclical balance sheet mechanisms in the Chinese financial sector. While this review is not the place to delve more deeply into a detailed explanation, it is worth noting that nearly every period of unexpectedly high growth in modern history has been followed by a surprisingly severe adjustment. This cannot be just coincidence.

The second way liability structures can constrain growth, while often poorly understood by economists, is actually well understood in finance theory. An economic entity will suffer from "financial distress" if debt has risen so much faster than expected, or growth is so much lower than expected, that economic agents become uncertain about how higher debt-servicing costs will be assigned to different sectors of the economy. This uncertainty forces these agents to react in ways that unintentionally but automatically intensify balance sheet fragility and reduce growth. This uncertainty is intensified if the debt burden rises and falls inversely with debt-servicing capacity, which almost always happens when economic growth is highly credit-intensive, and which seems to be happening in China.

While once again this review is not the place to explain why too much debt can limit the extent and effectiveness of policymaking and can lead to unexpected financial distress costs, it is worth noting that history provides many examples of countries in which unexpected surges in debt coincided with unexpectedly slower growth. It provides surprisingly few cases, however, in which policymakers were subsequently able to implement the "right" reforms and grow the economy at anywhere near the rates that were the expected outcome of these reforms.

While *Markets over Mao* is heavily skewed toward what I would call asset-side analysis, I disagree with Lardy's optimism mainly because of our different assumptions about liability constraints. This, I think, is why I value Lardy's analysis so highly, even though he expects more than twice as much GDP growth as I do during Xi's administration. It is also why I believe, and Lardy probably does not, that Beijing must prioritize debt management during the reform process if it wants to avoid a disruptive adjustment. And finally, while Lardy would probably interpret average GDP growth rates of 3%–4% as a sign of failure, I would argue that as China rebalances, these growth rates imply average growth in household income of 5%–7% and would represent an enormously successful adjustment by historical standards.

We tend to believe that sharp differences in growth forecasts reflect sharp disagreement about the evolution and structure of a country's underlying economy. When it comes to China, however, I think the main difference between optimists like Lardy and pessimists like me is probably in the very different assumptions we make about how balance sheets determine growth rates. While I think that Lardy, like most economists, has underestimated the important role of the liability side of China's balance sheet in the country's past and future performance, I have little doubt that when it comes to assessing the asset side, Lardy's book is invaluable and among the most useful in helping unravel the complexity of China's economic evolution. *Markets over Mao* will be read avidly by all sides in the contentious debate over China's future.

Who Is Responsible for China's Growth: The State or the Private Sector?

Yukon Huang

In *Markets over Mao: The Rise of Private Business in China*, Nicholas Lardy has taken on an arduous task in tracing the increasing role of the market in China over the past three and a half decades. This is a must-read book for China hands because of both the vast amount of information it presents and the skillfulness of one of the leading authorities on China's economy in

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dissecting that information. Critical to Lardy's argument is detailing the rise of the private sector relative to state-owned enterprises (SOE).

That this book is in fact so necessary is testimony to the widely diverging views on whether the market or the state is now the dominant force shaping China's economy. The answer is that both sides may be right. Lardy has proved his case in favor of the private sector on the basis of facts, but those who make the case for SOEs have a legitimate claim on the basis of sentiments about the how state directly or indirectly has been able to influence economic outcomes.

In meticulously analyzing all facets of this issue, Lardy has presented a convincing case that China's achievements have come from the rise of the private sector rather than from the virtues of state-led capitalism. A decade ago, this point might not have drawn as much attention. For most economists familiar with China it was already self-evident at that time that the country's sustained double-digit growth rates were the result of the increased efficiency brought on by market liberalization as China took advantage of a globalization process that altered price signals for firms.

As Lardy points out, early on the state had given up on controlling market prices for most consumer goods (chapter one), and by allowing private firms to expand while the state retreated, the dominant share of industrial activity became the domain of the private sector (chapter three). Moreover, financial liberalization made it possible for the private sector to secure an increasing share of bank lending. If this is clearly the case, then why do so many feel that China's economy is still largely state-driven?

The numbers showing that market forces and the private sector have steadily increased their presence are, importantly, about the direction of change. But others are also correct in assessing that the state continues to play an outsized role in influencing the behavior of economic entities, which is an argument about the extent to which the state is still involved.

The sense that the state is still dominant was revived by what happened in the aftermath of the 2008 global financial crisis. China's stimulus program of four trillion renminbis was huge in relation to the size of its economy at the time. Moreover, the speed at which the stimulus played out led to a surge in activity that unexpectedly pushed GDP growth above 11% when it should have been trending gradually down to the 8%–9% levels.

In retrospect, the stimulus was overdone and the resulting pressure in driving up debt levels has created a financial problem that the new leadership is still trying to cope with. Of relevance to this debate is that much of the stimulus was undertaken through credit expansion rather than through the budget and channeled to SOEs and also to local authorities through the borrowings of their affiliated local government financing vehicles (LGFV). These LGFVs were created to borrow directly from banks and other financial intermediaries since local governments are prohibited from doing so. LGFVs took on major responsibilities in ratcheting up investment, not just for infrastructure but also for commercial activities that would normally be more appropriate for the private sector.

Although a significant share of the stimulus-related lending ended up benefiting the private sector, the massive amounts fed into the coffers of state entities gave rise to a general perception that the state was in ascendancy at the expense of the private sector. This was not helped by some glaring examples of waste, as in the much publicized images of "ghost towns," that gave the impression that the state's interventions were getting out of hand.

The image of a powerful state sector comes out most vividly in the role that land development has played in driving economic expansion in recent years. Much of this development was accomplished by local authorities through their links with LGFVs. By tapping their access to state-controlled land, authorities were able to finance a range of investments even if many of the actual developers were private entities. That much of this activity was being financed by shadow banking involving complex arrangements between private and state-owned financial entities exaggerated the sense that the state was somehow manipulating things.

Also contributing to these perceptions are the revelations from the ongoing corruption campaign, which have fed into sentiments that the economic system is replete with rent-seeking activities involving state agents and well-connected party officials. This has reinforced the view that the state is still pervasive in terms of guiding economic activity, even if the form of its involvement has become more opaque.

The debate about the role of the state versus the private sector is also complicated by the complexities in defining the major economic agents in China's system. The standard view of an economy is centered on a profit-maximizing firm producing goods with capital and labor—hence the focus on private enterprises versus SOEs. With market-led capitalism, desirable outcomes are the result of competition between firms operating in undistorted markets. The state is seen largely as a regulator and facilitator of activity except for the provision of public goods.

In China, however, the state plays a major role in shaping growth outcomes that goes well beyond the role that SOEs play elsewhere. What makes China different is its regionally decentralized administrative system where local authorities are actively engaged in a broad range of economic activities that sometimes are in competition with the private sector. They are able to do so because of their access to property and bank financing through LGFVs as well as through their budget allocations. Unique to China, local governments also compete with other local governments both by attracting foreign and domestic firms to invest and operate in their localities and by supporting locally owned SOEs.

Because provincial leaders appointed by Beijing are assessed by how well they meet growth targets, this decentralized administrative system has incentivized local officials toward promoting productivity-enhancing reforms. Thus, China's economy includes both firms and local governments as major economic players. The latter are affected by incentives that are more open to political pressures. Yet there are limits to how far local authorities can go in their economic undertakings, given competition from other localities and fiscal constraints. Cross-regional competition has helped curb waste and ensure a modicum of efficiency, despite the high degree of state intervention in commercial activities.

Not just state-owned economic entities are subject to government interventions, but the more prominent private firms are also affected by the whims of the state in ways that cannot be easily measured. Their ability to expand and secure financing depends on their relationships with the party system that influences access to commercial opportunities. Some would argue that in China there is no such thing as a purely private firm of any significant size. All major firms are seen as subject to the state's influence whether they are state-owned or private.

China's statistics are also hard to interpret as indicators of the state's power. Lardy argues, for example, that the proposition that SOEs have monopoly power is flawed given that their profit margins are not much different from those of private firms (pp. 26–30). Yet one could also argue that while the profits of SOEs are being pulled down by their losses in serving politically driven mandates, these losses are offset by their monopoly profits elsewhere.

These relationships complicate our understanding of the market's role in guiding China's economic activities. Yet Lardy is basically right that the market is now the dominant force guiding economic behavior. This is one reason China is now seen as trending to a "new normal." With the state having lost the power to control outcomes, China's growth rate is sliding slowly to levels more characteristic of other market-based systems. As such, growth targets have become just targets rather than a floor that the state has the power to transcend as it consistently did in the past.

Where's the Government?

Joseph Fewsmith

In his new book, *Markets over Mao: The Rise of Private Business in China*, Nicholas Lardy takes on those who argue that China has developed a form of state capitalism that is directing and steering Chinese development. To the contrary, Lardy argues that Chinese development has been market-driven, not only in the 1980s as rural and urban markets were liberated from the restrictive policies of the Maoist era but also during the Hu Jintao and Wen Jiabao era when the creation of the State-owned Assets Supervision and Administration Commission (SASAC) and the high profitability state-owned enterprises (SOE) enjoyed in the early 2000s brought cries of "the state advances as the market retreats" (*guojin mintui*). Lardy argues the obverse: namely, that markets have continued to expand and the state has retreated. Today, SOEs account for about a quarter of industrial production and only 13% of urban employment (pp. 76 and 82). Lardy estimates that private enterprises employ 183 million urban workers, about two-thirds of all urban employment (pp. 83–84).

Much of Lardy's argument is convincing (and I am not going to argue economics with him), but it is less so when he discusses the role of the government. He disagrees with Steven Green's assessment that "China has a large and powerful government sector" (p. 138). Interestingly, Wang Jianlin, China's richest entrepreneur, agrees with Green. A recent article in the *New York Times* quotes Wang as saying, "It's a fact that China's economy is government-led, and the real estate industry depends on approvals, so if you say you can ignore the government in this business, I'd say it's impossible."[1]

In looking at the role of the party-state, it is useful to start with the definition of "private." As an economist, Lardy is primarily interested in whether the dominant ownership of enterprises is state or private. By this measure, Lardy estimates that the private sector, including privately owned foreign firms, generates about 60% of China's industrial output. He recognizes

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1 Wang Jianlin, quoted in Michael Forsythe, "Wang Jianlin, a Billionaire at the Intersection of Business and Power in China," *New York Times*, April 28, 2015 ~ http://www.nytimes.com/2015/04/29/world/asia/wang-jianlin-abillionaire-at-the-intersection-of-business-and-power-in-china.html?_r=0.

that this figure may overestimate the role of the private sector somewhat because "there must be some firms where the extent of the government's de facto control exceeds its ownership share" (p. 71). He also regards all agricultural production as private (p. 62). Although these assumptions seem reasonable, it is not clear how "private" private is. For instance, in the agricultural sector, the lack of private land ownership means not only that farmers cannot buy and sell land but also that they cannot mortgage their land to raise capital to start urban businesses. More important, local authorities often feel free to requisition land, giving farmers minimal compensation, in order to attract investment. So there are real limitations on the ability of farmers to control their supposedly private farms.[2]

Moreover, in the manufacturing sector, large private firms now often have party branches, and the party secretary, usually hired from outside the firm, is generally well-paid and often sits on the board of directors. This seemingly odd arrangement often works to the advantage of both the state and the enterprise. Party secretaries, many of whom worked previously in the government, can lobby the government for necessary permissions. In a polity in which the approval process remains extremely important (as Wang Jianlin, above, reminds us), this relationship is critical for the development of private enterprises. For the government, the expansion of the party into the private realm reflects a continued refusal to acknowledge a legitimate line dividing state and society as well as a continuing distrust of the private sector, despite all the studies that have shown that private entrepreneurs would rather be close to government than push for political change.[3]

Moreover, the government has been important in both stimulating and retarding economic development over the years. It was a government rethink of rural policy that brought about the household responsibility system in the late 1970s and early 1980s, and the annual Document No. 1 on rural policy that pushed those developments forward. Although land remained collectively owned (a largely ideological impediment to thoroughgoing privatization), these policies freed millions of peasants from the constraints of the old commune system (as Lardy recognizes, p. 60). Labor flowed into

2 Barry Naughton has noted that the government recently introduced a third category of rural rights, "land management rights," that may ameliorate some of these problems. See Barry Naughton, "Is There a 'Xi Model' of Economic Reform? Acceleration of Economic Reform since Fall 2014," Hoover Institution, China Leadership Monitor, no. 46, Winter 2015 ~ http://www.hoover.org/sites/default/files/research/docs/clm46bn.pdf.

3 See Joseph Fewsmith, *The Logic and Limits of Political Reform in China* (New York: Cambridge University Press, 2013), 135–39.

new township industries, local transportation, and long-distance peddling as peasants scoured out cheap products that they could sell for a profit in other markets. These were the results not simply of the market pushing against the state, but rather of the state promoting marketization. Similarly, the expansion of markets in the urban, industrial areas was not a given but was something fought for, often by drawing in foreign expertise, over many years.[4]

One reason the state, particularly the local state, pushed economic reform was because the development of markets and private enterprises—or market-oriented government-owned enterprises such as the township and village enterprises (TVE) of Sunan (southern Jiangsu Province)—boosted the local economy, provided jobs for workers (preserving social stability), and, lest we forget, boosted income, both licit and illicit, for local officials. The word "corruption" is not listed in the index to *Markets over Mao*, but it is clearly a part of the story. I would argue that it played a positive role in those first few years of reform and an increasingly negative role as the years have gone by.

The importance of government support for marketization was reflected when that support was removed briefly following Hu Yaobang's ouster in 1987 and again after the Tiananmen crackdown in 1989. Local economic growth in Wenzhou, the hotbed of the private economy, fell to zero in 1989. Premier Li Peng was highly skeptical of TVE development and that skepticism was reflected in lower growth rates for TVEs and private business in the following months. Conversely, it was after Deng Xiaoping's tour of the south in early 1992 when privatization really took off.[5]

The importance of government has also been reflected in who has been purged during the ongoing campaign against corruption. Of the 61 ministerial-level cadres detained for investigation as of March 1, 2015, 17 worked in the National Development and Reform Commission (NDRC) or its provincial-level counterparts. The most prominent of these targets was Li Tienan, who was deputy head of the NDRC and concurrently served as head of its Energy Bureau. Five of his co-workers in the Energy Bureau were subsequently detained. Five others who were investigated for corruption worked in the Price Bureau. Though it may be that most prices follow the market, the government retains control over important prices such as water and electricity, giving enormous incentive to would-be bribers. As Liu Tienan said himself after he was detained, the enormous concentration of

4 Julian B. Gewirtz, *Road to Reform: The Unlikely Partners Who Transformed the Chinese Economy* (Cambridge: Harvard University Press, forthcoming).

5 Fewsmith, *The Logic and Limits of Political Reform in China*, 115.

power in the hands of those with authority to approve projects provided a hotbed for corruption.[6] This cleaning out of the NDRC may well be a prelude to another round of marketization, as called for by the Third Plenum in 2013, but the need to clean up the NDRC and its counterparts at the local level suggests that the government has, at least until the present, continued to play an important role in directing development.

It is, of course, not only the NDRC that has proved corrupt but also the government at all levels. As one former official said, "Become a small section chief, without spending money? Show me. If he really has that ability, I'll call him my daddy."[7] And because government officials have needed to purchase promotions, the money has had to come from private enterprise. In return, the government provides permits and favorable policies. This close relationship between the party-state and enterprise has been particularly on display in Shanxi Province, where mine owners regularly gave generous gifts to local officials, many of whom have since been detained in the crackdown on corruption.[8]

It has been suggested that in places where law is weak, corruption arises to provide predictability. No doubt that predictability has underlain the marketization and privatization that Lardy discusses, but corruption in the long run is more expensive and less certain than law. At this year's National People's Congress, one person confessed that he had offered the former vice chair of the Central Military Commission, Xu Caihou, 10 million renminbi for a promotion, but someone else had secured the promotion with 20 million renminbi.[9] No doubt the same thing happens in the economy. One person wants a particular piece of land or approval for a project, but somebody else wins the approval not through market competition but rather through personal connections or a higher bribe. Such uncertainty ultimately undermines the legitimacy of the political system, which is one reason Xi Jinping is carrying out his campaign against corruption.

Interestingly enough, a whole body of literature, both in Chinese and in English, is based on the notion that government can be effective in

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6 Joseph Fewsmith, "China's Political Ecology and the Fight against Corruption," Hoover Institution, China Leadership Monitor, no. 46, Winter 2015 ~ http://www.hoover.org/sites/default/files/research/docs/clm46jf.pdf.

7 "Tanguan leiren yanlun: Buhuaqian nengdang xiaokezhang, neibenshi wohanta daye" ["Corrupt Official's Thunderous Words: Be a Small Section Chief without Spending Money, If He Has That Ability, I'll Call Him My Daddy"], *Ifeng*, July 6, 2011 ~ http://finance.ifeng.com/news/pic/detail_2011_06/07/6862510_0.shtml.

8 Fewsmith, "China's Political Ecology."

9 Michael Forsythe, "Chinese Ex-General, Charged with Corruption, Dies," *New York Times*, March 15, 2015.

stimulating the economy. According to this literature, officials are evaluated on the basis of how they will develop the economy they are in charge of. If it is really just market forces driving development, then this whole body of literature needs to be rethought.

Another measure of the strength of government is the weakness of the NGO sector. China has some 280,000 officially registered NGOs and probably many times that number of unofficial NGOs. No doubt Chinese society benefits from these NGOs in a variety of ways, but they have not developed into the sort of independent civil society that many hoped for. This is largely because the party-state remains strong, and any efforts to move beyond the permissible parameters as defined by the state are met with repression. The NGO sphere may be a long way from the economy, but its weakness suggests that the scope of the "private" remains largely defined by the state.[10]

I have no doubt that Lardy's data is correct. But without the politics, the implications of this data for understanding how China's political economy works are less clear.

10 Timothy Hildebrandt, *Social Organizations and the Authoritarian State in China* (New York: Cambridge University Press, 2013).

The Contradictions of China's Political Economy

Charles W. Freeman III

The central conclusion of Nicholas Lardy's compelling new book, *Markets over Mao: The Rise of Private Business in China*, that the state-controlled sector has been much less important to China's economic development over the past 30 years than the nonstate sector should not be much of a surprise to long-time China watchers. As early as the late 1990s, Chinese economists and other scholars, particularly in Shanghai, were quietly positing that firms in the nonstate sector were contributing as much

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as 70% to Chinese economic output and were operating more than twice as efficiently as their state-controlled counterparts.

Yet even many Chinese scholars and business people have suggested that the success of private Chinese business has come in spite of official government policy rather than as a natural result of that policy. According to this narrative, the private sector has faced a gauntlet of official challenges, ranging from political favoritism of state-owned enterprises (SOE) to restrictions on credit and other financing opportunities to limitations on market access across provincial lines. Lardy's careful analysis debunks the underpinnings of this narrative and documents the evolution of China's economic and regulatory environment into one that has increasingly removed obstacles to the growth of the Chinese private sector.

Foreign and Chinese analysts frequently fall into the trap of trying to pigeonhole the Chinese economy into a framework that accounts for China's Communist Party–dominated political system. The language of China's "socialist market economy" and the post–financial crisis effort by many Chinese to define a "China model" presume the centrality and dominance of the state sector in the economy. Indeed, China's most recent constitution, adopted in 2004, recognizes the contribution of the nonstate sector but firmly establishes the preeminence of the state-owned sector.[1] While official emphasis on the role of SOEs may be more than lip service, however, and Lardy describes the political backdrop that continues to motivate support for a strong state sector (pp. 145–51), his analysis demonstrates the systematic removal over 30 years of the advantages previously enjoyed exclusively by SOEs.

Conventional wisdom has held that the administration of Hu Jintao and Wen Jiabao, from 2002 to 2012, witnessed a retrenchment and renaissance of state-owned interests after the whirlwind of market-oriented economic reforms that culminated in China's entry into the World Trade Organization in late 2001. Lardy presents compelling evidence that even this period of relative quiet in China's economic reform period did not alter the fundamental shift toward private-sector dominance (pp. 48–58). That shift appears to be accelerating with the emphasis on the "decisive" role of the market that emerged from the Third Plenum of the 18th Party Congress.

1 Chapter 1, Article 7 of China's Constitution reads as follows: "The State-owned economy, namely, the socialist economy under ownership by the whole people, is the leading force in the national economy. The State ensures the consolidation and growth of the State-owned economy." *Constitution of the People's Republic of China*, chap. 1, art. 7 (amended 2004) ~ http://www.npc.gov.cn/englishnpc/Constitution/node_2825.htm.

The proposed changes that emerged from the subsequent Fourth Plenum to make the government less focused on approving or denying private economic activity than on *ex post facto* regulation seem further aimed at bolstering the interests of the private sector.[2]

President Xi Jinping's twin emphases on reducing the role of the state in economic decision-making and consolidating political control can be confounding to outside analysts of China's political economy. Can the political role of the state be strengthened even as the state further reduces its direct leverage on the country's economy? Is one aim a precursor for another? As Lardy documents, much of China's economic success has come along with, if not because of, a retreat of the state and the party from a controlling role over nonofficial decision-making. Reasserting some aspects of that control for political purposes, including the preservation of party primacy, may be difficult to square with efforts to liberalize the economy. Efforts to restrict access to global data networks for political auspices, for example, are one such measure that may reduce the competitiveness of the Chinese economy.

There are other examples of strong, nonpluralist governments successfully overseeing market-based economies, but none have the size and economic complexity of China. Much of the political rhetoric in Xi Jinping's China harkens back to a far less liberal time in China's economic history. However, for those analysts postulating a return to greater centralized control as a result of Xi's political strategy, *Markets over Mao* is an important counterpoint.

For the foreign business community trying to understand its role in Xi's China from the competing economic and political signals, Lardy's analysis is both hopeful and sobering. The emphasis on building a competitive, market-based business environment and enhanced role for the private sector is cheering. Still, there are signs that removing the advantages of SOEs and conferring them on private sector companies does not mean all private sector companies are created equal. There is an undoubted streak of nationalism to current Chinese policymaking, and while the Chinese government may be embracing private enterprise, it is far from clear that foreign enterprises will be swept up in that embrace.

2 The development of a "negative list" approach to permissible economic activity that first began to coalesce in the context of the negotiation of a U.S.-China bilateral investment treaty has been broadly accepted at the national, provincial, and local levels in China as a model for new investment approvals.

Foreign companies have frequently pointed to industrial policies emerging from the National Development and Reform Commission (NDRC) and other planning agencies in China as evidence of continued state interference in China's market, particularly since China's entry into the WTO. Lardy correctly points out that many of these policies have not been successful (p. 57). To the extent these policies have been aimed at supporting inefficient state-controlled enterprises, however, a shift in policymaking designed to support the Chinese private sector may yield more success. That in turn could embolden further industrial policymaking that might limit competitive opportunities for foreign companies in China's marketplace. One can point to new evidence of procurement policies, subsidies for domestic innovation, anti-monopoly policies, and other measures to support that concern.

As Lardy suggests, however, U.S. companies are not without advantages in their home market, including the receipt of national and local subsidies (p. 35). They may now be facing increasingly efficient, globally oriented private Chinese competitors who are receiving a variety of support mechanisms in their home market. Xi Jinping's vision of a "Chinese dream" clearly includes private Chinese entrepreneurs. Will foreign companies be able to share in that vision?

Author's Response: China Has Grown Because It Has Grown More Capitalist

Nicholas R. Lardy

The five thoughtful essays reviewing *Markets over Mao: The Rise of Private Business in China* remind us of the complexity of China and the seeming inevitability of widely varying interpretations of contemporary economic trends and events. Different perspectives stem from varying disciplinary backgrounds, research agendas, and a host of other factors. Thus the review essays are a useful guide to perspectives that are sometimes different from those articulated in *Markets over Mao*.

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As is suggested by the subtitle, the central theme of the book is that China's rapid growth after 1978 is largely the consequence of the growing role that markets play in resource allocation and the rapid expansion of private businesses that have operated increasingly successfully in this new emerging environment. The reviewers agree that private firms are more dynamic and thus have largely displaced state firms in broad swaths of the economy. They argue, however, that the book understates the influence of the state, and some of the reviewers even imply that the book argues that China's economy is entirely market-driven. But the book also points out that the state still controls fully one-third of all investment and demonstrates clearly that the role of the market is very attenuated in upstream oil and gas, electric power, and modern businesses services, such as finance and telecommunications, largely because the government has severely limited entry by private firms in these domains. The incumbent state firms in these sectors, shielded from competition, have become extremely inefficient and, in fact, are an increasing drag on China's economic growth. Thus the analysis in *Markets over Mao* shows that China remains short of a liberal market economy. The book concludes that the way forward is to implement the two key economic reforms embraced at the Third Plenum of the 18th Party Congress—i.e., eliminating most monopolies and fostering increased competition so that the market becomes the dominant force in the allocation of resources throughout the economy.

How then do we measure the role of the party-state in the economy other than by ownership and the control of investment? Kellee Tsai in her review notes that the top management of the largest state firms is appointed by the Organization Department of the Chinese Communist Party, which is a point made in *Markets over Mao*. But the 53 firms for which this is the case lie almost entirely in the segments of the economy that have never been opened up to competition from private firms. As a result, the role of the party there tells us little about its role in China's private sector, which in 2012 consisted of 6.5 million private enterprises and 40.6 million household businesses (the latter not organized under the Company Law and thus not classified as enterprises).

Yukon Huang argues that the competition among provincial and local governments in attracting foreign and domestic investment to promote growth is unique to China and demonstrates that the state plays a major role in shaping growth that goes beyond its direct ownership of enterprises. Yet competition among U.S. states to attract foreign and domestic investment is pervasive, demonstrated clearly, for example, in

2013 when 22 states offered tens of billions of dollars in subsidies in an attempt to attract a new Boeing aircraft production facility. Huang also argues that private firm access to credit "depends on relationships with the party system." Yet he presents no evidence that this is the case, and it seems unlikely that the party could exert much detailed control of the roughly 15 trillion renminbi in bank loans outstanding to the millions of private firms and household businesses in 2012.

Joseph Fewsmith believes that the government regulatory and approval process is another mechanism through which the state exerts control of private firms. But the extent to which these approvals are substantially more onerous than in market economies is not clear. Food trucks, a prime example of entrepreneurial activity in Washington, D.C., and many other large U.S. cities, require not only registration of the vehicle and licensing of the driver, but registration of the retail food business, approvals from the local health authorities, and so forth. Real estate is an even more highly regulated industry in most jurisdictions in market economies. In Washington, D.C., for example, developers not only must comply with local zoning laws; they also must acquire appropriate building permits for a project of almost any size, ranging from new construction to attaching an awning to an existing building; acquire a separate raze permit if the project involves tearing down a previously existing structure or building (and show a certificate of insurance for $500,000 in coverage to raze a structure larger than 500 square feet); acquire public space permits if the project requires a dumpster in a public space, any sidewalk construction or repair, or the erection of flag poles, planter boxes, and so forth in public space; acquire additional separate water and sewer excavation permits for projects involving water and sewer pipe installation or connections to same in the street; and acquire supplemental system installation permits for projects involving the installation of air conditioning, refrigeration systems, plumbing fixtures, or electrical and gas appliances. Property developers must also comply with regulations and acquire separate permits for projects that involve asbestos, lead, and other toxic substances or could affect storm water management or water quality. In addition, developers must comply with regulations defining legal construction hours and submit to recurring safety inspections to ensure that the project is in compliance with applicable construction codes. Complying with these regulations and obtaining the relevant permits involves a number of separate local government agencies, including the D.C. Office of Zoning, the Department of Consumer and Regulatory Affairs, the District Department of Transportation, the District

Department of the Environment, and the D.C. Water and Sewer Authority. Wang Jianlin, the chairman of China's largest real estate development company, may complain that in his business it is impossible to ignore the Chinese government, but if his firm entered the property development business in Washington, he probably would feel right at home.

One indirect indicator of the role of the party-state in the Chinese economy is the pace of private business formation. As already noted, millions of private firms had been established in China by 2012. *Markets over Mao* analyzes the acceleration in the formation of private businesses in response to the government's reduction of the minimal capital requirements to register a business and its reforms of the administrative examination and approval system, both of which were launched in mid-2013. In the twelve months ending in February 2015, 3.8 million new enterprises were created, an increase of 50% over the previous twelve-month period. More than 90% of these firms are private. It seems very unlikely that entrepreneurs would be rushing headlong to establish new private businesses if the party-state were exerting undue negative influence on existing private firms. Indeed, one of the contributions of the book—acknowledged in both Charles Freeman's and Joseph Fewsmith's essays—is its demonstration of the many ways in which Chinese party-state policy evolved from being almost entirely hostile to private business in the early 1980s to expanding the role for markets and facilitating the emergence of an increasingly robust private sector.

Contrary to Michael Pettis's assertion, the book does give some attention to the liability side of the Chinese economy. I note the huge buildup of debt starting in the fourth quarter of 2008 and analyze the challenges this debt poses for financial stability. But in *Markets over Mao* I point out that China differs in several critical respects from other countries where rapid debt buildups have precipitated financial crises. To begin with, China's national saving rate, reflecting the combined savings of households, corporations, and the government, approaches 50% of GDP, significantly higher than any other economy in recorded history. Like households, countries that save more can sustain higher debt burdens. Second, the vast majority of this debt is in domestic rather than in foreign currency. Indeed, the ratio of China's gross external debt to GDP is far and away the lowest of any Asian country, and of course on a net basis China has long been a very large creditor to the rest of the world. Thus, its debt does not involve any significant currency mismatch, a major contributor to many financial crises. Third, the majority of this debt has been extended by banks, and China's systemically important banks are financed entirely by deposits rather than through the wholesale market, where sudden stops in funding can precipitate a crisis, such as in the case of the spectacular collapse of Lehman Brothers in 2008. Moreover, the loan-to-deposit ratio is approximately 75% for the banking system as a whole. In short, there is ample liquidity and relatively little leverage in the banking system compared with other countries that have had banking crises. Finally, the government has enormous scope to further increase bank liquidity should that become necessary. Other factors, too numerous to list here, also suggest that a banking crisis is far from certain in China. Thus, unlike Pettis, I do not believe that a dramatic further decline in China's growth rate to an average in the low single digits over the next five years is inevitable.

Finally, what are the prospects that the reform agenda of the Third Plenum will actually be implemented? Kellee Tsai argues that the obstacles go beyond the vested interests that I discuss in *Markets over Mao*, particularly the reluctance of the party-state to relinquish control of strategic sectors. Yet it would be easy to overestimate this constraint. A decade ago the chairman of the State-owned Assets Supervision and Administration Commission (SASAC) identified steel as a "pillar industry" requiring "strong state control." At the time, the share of output produced by state steel companies had already slid from close to 100% when reform began to 47%. As pointed out in *Markets over Mao*, by 2011 the state share had fallen to only 37% of output. Since the book was completed, new data shows the share sinking further to only 33% in 2013. The SASAC identified civil aviation and the defense industry as even higher priorities—so-called strategic sectors in which the state must "guarantee absolute controlling power." But top leaders in the Aviation Industry Corporation of China, which is the country's leading aerospace and defense company, now recognize that sustainable development of the commercial aviation industry in China requires the active participation of Chinese private enterprises. Even the military industry is coming under some pressure from private firms after the General Armament Department (GAD) of the People's Liberation Army in early 2015 launched a procurement website that, according to the director of the planning department of the GAD, "aims to get qualified, private businesses involved in weapons research and production in a bid to improve competitiveness and efficiency."[1]

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1 "China Starts Military Procurement Website to Boost Transparency," Bloomberg, January 5, 2015 ~ http://www.bloomberg.com/news/articles/2015-01-05/china-starts-military-procurement-website-to-boost-transparency.

All these developments suggest that as the party-state weighs the complex trade-offs between state ownership and control, on the one hand, and efficiency and growth, on the other, it is not uniformly deciding in favor of the former and against the latter. As I wrote in the concluding paragraph in *Markets over Mao*, I believe that a party that has staked its legitimacy on delivering sustained growth of income and rising living standards will increasingly opt for efficiency and growth rather than state ownership and control. ◈