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# Evolution of government and market under China's reform era: through the perspective of state capacity

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## Abstract

There are two main stream theories explaining China's rapid economic development in the reform era: new institutionalism and developmental state theory. Realizing the weaknesses of two main stream theories and based on China's unique experience as both a transitional economy and developing economy that experienced rapid industrialization and marketization, scholars also developed other theories with some revisions of the above two mainstream theories. While these theories have very different focuses, they agree on the importance of state capacity. The author argues that the Chinese Communist Party composes the institutional foundation of state capacities to promote economic growth and build market institutions, and discusses three important aspects of how party strength and state capacity helped the market transition, government restructuring and enterprise reform. The future challenges are discussed in the conclusion.

**Keywords:** State capacity, Government-market relation, Economic development, Political party

## Introduction

In the last four decades of the Reform and Opening-up process in China, the most remarkable achievement was 40 years of continuous rapid economic growth. China's GDP grew at an average annual double-digit growth rate, and China entered the groups of middle-income countries in 1999 and upper middle-income countries in 2010. In 2009, China's GDP surpassed Japan's to become the world's second largest economy. Manufactured products accounted for more than 97% of China's exports, which made China the new "world factory" after Britain, the United States, Japan and Germany since the Industrial Revolution in the eighteenth century. In 2017, China's per capita GDP reached 8640 US dollars, and the gross national product jumped rapidly from 364.5 billion yuan in 1978 to 82.7 trillion yuan in 2017, an increase of 226 times. The share of its GDP in the world economy increased from 1.8% in 1978 to approximately 15% in 2017. In addition, people's living standards have rapidly improved. More than 700 million people have been relieved of extreme poverty, and the living standards of people in urban and rural areas have substantially improved. In 1978, the per capita living expenditure

of urban households was 311 yuan, and the Engel coefficient was 57.5%; by 2017, these two numbers had changed to 24,445 yuan (78 times' increase) and 28.6%, respectively; in 1978, the per capita living expenditure of rural households was 116 yuan, and the Engel coefficient was 67.7%. By 2017, the numbers had changed to 10,955 yuan (94 times' increase) and 31.2%.

Unlike the traditional extensive economic growth model that relies on the increased input of factors of production, including capital, land and labor,<sup>1</sup> economic growth after 1978 was accompanied by structural and institutional transformations, including marketization, industrialization, and urbanization. Policy-makers and scholars around the world have investigated the reasons behind the miracle of China's economic growth and have reached different conclusions. In general, however, some basic consensus has been reached. One consensus is the repositioning of the government and the market. The resources that are supposed to be allocated by the market should be left to the market, while others, including public services and infrastructure, should mainly be provided by the government, and State-Owned Enterprises (SOEs) should play a strategic role. In the terminology of Justin Yifu Lin's new structural economics, China has invented a development strategy to build an effective market and an active government for developing countries (Lin 2012).

At the same time, the successful experience of China's economic development is mainly due to its early and middle stages of industrialization—escaping the poverty trap and entering the ranks of middle-income countries. However, there are still many uncertainties when China faces the challenge of further development, escaping the middle-income trap. These uncertainties may include whether the current government and market model can help China escape the middle-income trap, whether China requires further institutional reform and how to reform it. We need to further explore the theory and practice related to these questions. Moreover, changes in the international environment have brought new challenges to China's sustainable development.

This paper is composed of sections on the theoretical framework, historical evolution, empirical strategies, and future challenges. Through linking the literature both in Chinese and English<sup>2</sup> with the practices, this paper will discuss the transitions and experiences of the relationship between the government and the market in China and will summarize some empirical models and propose policy recommendations for future challenges.<sup>3</sup>

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<sup>1</sup> Huang (1990, 1350–1988) defined the way to increase total output by investing a large amount of labor on limited land as growth without development, that is, "involution", which can also be considered a way of diminishing marginal benefits.

<sup>2</sup> There has been a large body of literature on the theory and practice of China's reform and opening-up agenda, especially research on the government and market from the perspective of political science and economics and political economy. Because of the word limit of this paper, we can only focus on specific parts rather than paying attention to every part of this literature.

<sup>3</sup> This paper does not intend to propose an original or comprehensive theory of the Chinese model of government and market. Readers can refer to other relevant studies. See Zhang et al. (2011). Since there is a specialized paper in this series, this paper will pay more attention to the formation of the market as a one-way transition and development rather than the important aspects of the relationship between government and market in which government acts as social protector and welfare provider to promote reverse transition, in Polanyi's explanation from the perspective of political economy; see Polanyi (2001).

### Theoretical framework

Regarding China's economic growth, there are two explanations: (1) neo-liberalism, especially neo-institutionalism based on neo-liberalism, which emphasizes the rise of private property rights, the role of the market and free competition, and the improvement of resource allocation efficiency and incentive mechanisms; (2) developmental state theory, which emphasizes state capacity and the role of the state.<sup>4</sup>

These two theories closely correspond to market-led and government-led theories, respectively. Correspondingly, academia is divided into two schools regarding what kind of relationship between government and market can better promote economic growth. One side supports the market-led way, advocating that the government should guarantee the disinterested system of the effective operation of the market. In other words, the government should provide legal protection and market supervision at the micro level and economic regulation at the macro level to ensure the smooth operation of the market, while enterprises can promote economic growth under the market mechanism. The other side supports the government-led way of promoting economic development via selective industrial policies and infrastructure construction.

However, neither of the two mainstream theories pays attention to the special background of China's economic development. Like other developing countries, there are several challenges for China's industrialization. The first is to achieve capital accumulation and industrialization with little agricultural surplus and thus to escape the poverty trap. The other is to establish a market system from the historical heritage of the plan economy so that the market rules can replace (or at least dominate) social (political) rules. However, as a transitional economy, China's economic development differs from that of other developing countries in major aspects: how could private property rights emerge and develop under a socialist planned economy? How could the market emerge and develop from the plan economy? How could the logic of the market override the logic of power, or, in Polanyi's terms, how could the market de-embed from politics? To answer these questions, scholars proposed theories within the state-led and market-led dimensions that emphasize the importance of government "planning" and SOEs' control over strategic industries as well as the new structural economic theory represented by Justin Yifu Lin, which emphasizes the alignment between an efficient market and a well-functioning government. There is also a more extreme theory of "market in state" by Huang and Yongnian Zheng that argues that the market should promote economic development for the state while the state dominates the market.

### New institutionalism and its relevant theories

Based on Adam Smith's insights, neo-institutionalist economics emphasizes that the private property rights empower people with economic incentive and market is the best mechanism for resource allocation. What the government needs to do is to make "the institutions right" and correct the "incentive mechanism" so that people can do their best and the economy will develop accordingly. The state only needs to protect private

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<sup>4</sup> Wu (2018, 31–33) pointed out that in the early 1980s, political, economic and academic circles generally proposed three institutional models for economic system reform: the market socialism model based on the experience of the Soviet Union and Eastern Europe, which basically disappeared in the mid and late 1980s; a government-led market economy model based on the experience of East Asia; and a free market model based on the experiences of Europe and the United States. The formulation of this paper's argument corresponds to this argument.

property rights and free market competition and ensure order and provide basic public services. As North (1994, 21) proposed, “The existence of a state is essential for economic growth; the state, however, is the source of manmade economic decline.” This classical argument reveals the two objectives of the state (the ruler): one is to set up the basic rules of competition and cooperation by which an ownership structure can be formed to maximize rulers’ income rent; the other is to reduce transaction costs within the framework of the first objective to promote the maximization of social output and thus increase the tax revenue of the state. Therefore, for rulers, how to make their commitment to protecting property rights credible is a prerequisite for the sustainable development of the economy, which requires a delicate institutional setting (North and Weingast 1989).

In the past four decades, strong evidence for the new institutionalism theory has been confirmed by the transition from a plan economy to a socialist market economy, the separation of government and enterprises, the development of township and village enterprises, the growth of private enterprises, and the deregulation of foreign trade and investment in China. New institutionalism theorists believe that the process of reform and opening-up is also a process of gradual improvement of private property rights protection (market-preserving federalism) and the better allocation of resources (comparative advantage theory in the international economy, dualistic economic structure theory in domestic economic growth).

Market-preserving federalism refers to the decentralization between local governments and the central (federal) government and competition among local governments, by which the power of central and local governments can be effectively limited. This restriction makes it possible for the state to make a credible commitment to safeguarding the market rather than interfering in the market and even confiscating the wealth created by the market for its own interests (officials’ interests). In addition to preserving markets and promoting economic growth, fiscal federalism is believed to bring other benefits, such as better-quality public goods provision, making government closer to the citizens (and thus more accountable). Yingyi Qian and colleagues even proposed the theory of “federalism, Chinese style”, a Chinese version of market-preserving fiscal federalism. This theory contends that the decentralization reform between the central and local governments successfully provides a constitutional basis to limit the predatory tendencies of the state, although China has not carried out deep political reform, including rule of law and constitutionalism. This constitutional basis comprises decentralization and restriction between the central and local governments and checks and balances among local governments through “voting by foot”, which promotes China’s rapid growth (Montinola et al. 1996). There are five conditions that market-preserving federalism needs to fulfill, but researchers have found that these five conditions were not well met in this case, which weakens the explanatory power of the theory (Yang and Nie 2008; Tsai 2011; Cai and Treisman 2016). However, this theory still provides a coordinate system to better understand China’s economic reform (Table 1).

Lin et al. (1994) argue that optimizing the efficiency of resource allocation according to the law of comparative advantage, is the foundation of China’s economic growth miracle. At any particular stage in economic development, a country’s resource endowment structure determines its relative comparative advantage and optimal industrial

**Table 1** Essential conditions for an ideal market-preserving federalism and consequences when corresponding conditions are not met

Essential conditions for ideal market-preserving federalism	Results when a state does not satisfy the corresponding conditions
A hierarchy of governments with a delineated scope of authority (for example, between the national and sub-national governments) exists so that each government is autonomous within its own sphere of authority	A unitary system under which the central government can recentralize power discretionarily; ambiguous division of fiscal revenue and expenditure responsibilities at the provincial level
The subnational governments have primary authority over the economy within their jurisdictions	Undermine the competition among local governments and their capacity for implementing policies according to local conditions; clarify economic autonomy since the mid-1990s
The national government has the authority to police the common market and to ensure the mobility of goods and factors across subgovernment jurisdictions	Undermine regional competition, resulting in the prevalence of rent-seeking and corruption and inefficient resource allocation before the mid-1990s; restrict the mobility of production factors, which were effectively improved after the tax-sharing reform
Revenue sharing among governments is limited and borrowing by governments is constrained, so all governments face hard budget constraints	Soft budget constraints; more corruption, spoils-sharing and endless subsidies for inefficient enterprises
Institutionalized decentralization	The central government can recentralize power discretionarily and threaten the autonomy of the local governments that seek policy independence, which may result in the opportunism of local governments

development strategy. Therefore, developing countries should choose industries according to the comparative advantages determined by the factor endowment structure at each stage of development so that factor production costs will be the lowest. If the government helps enterprises overcome the bottleneck restrictions of soft and hard infrastructure to reduce transaction costs, competitive advantage can be formed. With competitive advantage, profits can be created, and capital will be accumulated. In this process, developing countries can also make use of the advantage of underdevelopment and introduce new technologies and industries at lower costs and risks to accelerate economic development and transformation and thus catch up with developed countries. China's reform and opening-up are mainly to adjust the distorted allocation mode of factors of production (capital-intensive) during the plan economy period to a labor-intensive one, which is in better accordance with China's resource endowment.

The dual sector model (Lewis 1956), which emphasizes the population mobility between different production sectors under market conditions can bring demographic dividends, is also used to explain China's rapid economic development from 1978 to 2008. According to Lewis's dual sector model, Fang Cai argues that the basic task for most developing countries is to achieve development and complete the transformation of the dual economic structure by properly coping with urban–rural relations. Transitional countries are also faced with the task of how to integrate the urban and rural economy and achieve balanced development on the basis of market allocation of resources through the development of the product market and the production factor market. In the period of the planned economy, according to the logic of the priority development strategy of heavy industry, lowering the threshold of industrialization requires lowering labor costs and thus lowering the price level of agricultural products, which will inevitably lead to the implementation of the state monopoly of purchase and marketing as well as the people's commune system and household registration system that control the flow of production

factors. Therefore, the micromanagement system that distorts the incentive mechanism and the urban–rural relationship that is biased toward urban areas are both inevitable results of the priority development strategy of heavy industry and its endogenous traditional system model. Accordingly, market-led reform requires a fundamental change in the structure of urban–rural relations, which depends on a thorough reform of this traditional development strategy and the traditional system derived from it (Cai 2008). Cai (2007) reveals the effect of reform and opening-up on institutional change in terms of how China achieves rapid economic growth through the utilization of population dividends, the exertion of comparative advantages, the improvement of total factor productivity and participation in economic globalization.

Market-preserving federalism underscores the incentive promotion mechanism triggered by property rights protection, while comparative advantage theory and the dual sector model underline the improvement of efficiency brought about by the optimal allocation of resources. Both of these theories insist on the fundamental role of the market fulfilled by institutional reform. As Wu (2018, 1) notes, “The most important factor that impels China’s economic growth is that the expansion of the market gives a certain space for individuals and enterprises to choose. This expansion of free choice based on the market has created favorable conditions for the effective integration of labor, capital and technology in specific time and space slots, which thus remarkably unleash China’s economic growth potential.”

#### **Developmental state theory and its theoretical revision**

Contrary to neo-institutionalism, the developmental state theory based on East Asian development experience emphasizes that a highly autonomous and cohesive government should intervene in the market by implementing selective industrial policies and even intentionally distorting the market, protecting and cultivating infant industries, and thus promoting industrial upgrading and economic development. According to developmental state theory, a global economic system based on free trade and free investment, despite being based on static comparative advantage, will only result in economic dependency or dependent development rather than substantial development for developing countries. Therefore, to achieve rapid growth, developing countries must obtain effective government intervention to selectively protect and support infant industries to make them internationally competitive.<sup>5</sup> Other scholars propose theories such as “local state corporatism”, the “local developmental state” and the “entrepreneurial state”, emphasizing the important role of government, especially the local government, in promoting market transformation and economic development. Zheng and Huang (2018) also raised the theory of “market in state”, suggesting that the state has always occupied a dominant position and that the market is only a tool that serves the state’s goals.

However, many scholars believe that China’s development model is different from that of the developmental state. For example, Heilmann (2019) summarized the similarities and differences between China’s state-led development model and the East Asian developmental state model (Tables 2 and 3).

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<sup>5</sup> There is a large body of literature by Chinese scholars on developmental state theory, see Haggard (2018) for a comprehensive review.

**Table 2** Similarities and differences between China's State-led development model and East Asian developmental state model

	East Asian Developmental States	China (Since 1993)
<b>Similarities</b>	Building and preserving the market through policy intervention and guiding social investment through industrial policies for the purpose of national prosperity; paying attention to infrastructure construction	
<b>Strategic Policy Coordination</b>	Legacy of the plan economy with strong binding strength	Market-led planning, forecasting and guidelines with weak binding strength
<b>Main Types of Enterprises</b>	SOEs are dominant, while private enterprises lack policy influence	Private enterprises play an important role in the policy-making process
<b>Plan Making</b>	Interaction between the public and private sectors, with an emphasis on informal private relations	Top-down planning

Source: Heilmann (2019)

Walder (2019) also compared the similarities and differences between two models

**Table 3** Similarities and differences between China and the developmental State in East Asia

Similarities and differences between China and other East Asian countries	
<b>Similarities</b>	<p>Land reform, which led to changes in land ownership and use rights and further changed under-developed production relations</p> <p>Government's support and preferential industrial policies</p> <p>Strong support for the preferential development of an export-oriented economy and the successful upgrading from a low-end industrial system to a high-end industrial system</p> <p>Implementing financial repression policy</p>
<b>Differences</b>	<p>China's dependence on foreign direct investment (FDI) is significantly higher than that of other East Asian developing countries</p> <p>China's dependence on SOEs, state-owned banks and state-owned assets such as land and mineral resources is also significantly higher</p> <p>The diversity and openness of China's political system are significantly lower than those of Japan, Korea, and Taiwan, China</p> <p>China's economic development is not synchronized with the economic development in other East Asia countries and shows obvious hysteresis</p>

Source: Walder (2019)

China's reform largely stemmed from decentralization in the economic sphere, which is believed to provide local governments with the impetus to promote economic growth and act as a "local developmental state". In the early stage, the reform delegated autonomy to the local governments started in the form of a fiscal contract system (dividing the kitchen for meals, *fenzaochifan*, "分灶吃饭"). Local governments at different levels, from provinces to townships, were empowered the responsibilities (expenditure responsibility) for local financial expenditure and the rights (fiscal power) to retain a large share of local fiscal revenue. As Oi (1992) notes, one of the important outcomes of the fiscal contract system was "local state corporatism". In other words, the local government had many characteristics of a business corporation, officially acting as the equivalent of a board of directors and striving to set up township and village enterprises to promote economic development and increase fiscal revenue and thus achieve better public goods provision and policy implementation as well as improve the welfare treatment of cadres.

Jean C. Oi argues that fiscal decentralization and de facto administrative decentralization enable local governments to adopt policies that suit local conditions to promote local economic growth. Whiting (2001) and Tsai (2007) propose other local development models, such as the Sunan model that relies on collective enterprises (closest to the local state corporatism model), the Wenzhou model that relies on private enterprises, the export-oriented Pearl River Delta model that relies on foreign investment and other models in underdeveloped areas and areas with more SOEs.<sup>6</sup> Even though the tax-sharing reform in 1994 enforced large-scale fiscal centralization, which greatly increased the proportion of the central government's fiscal revenue to the total government revenue, China is still a highly decentralized state from the perspective of expenditure.

However, some scholars have found that China's decentralization is confined to fiscal decentralization, while the political and administrative systems are still highly centralized. Political centralization, especially its economic growth-oriented cadre assessment system, prevents the local government from becoming a predatory government that aims to maximize its fiscal revenue. Instead, this political centralization drives the local government to develop local economies on the basis of local conditions to meet the assessment of economic development by its superior supervisor (Whiting 2001). Insisting on political centralization that is mainly manifested in the principle of the party supervising cadres, the central government formulated a series of cadre assessment standards that underscored the performance of local governments in promoting economic development and increasing tax revenue. This preference was drawn from faith in the motto that "development is the absolute truth" and the consideration of the legitimacy of performance (Yang and Zhao 2013). Political centralization also made it possible to successfully enforce the tax-sharing reform aimed at fiscal recentralization in 1994 and a series of other market-oriented reforms aimed at building a national common market. In contrast to Russia in the 1990s, the situation was the opposite: the high extent of political decentralization made the central government lose leverage over the local governments and led to economic stagnation and even negative growth (Solnick 1996; Treisman 1999).

Consistent with overseas scholars, some Chinese scholars have also proposed theories such as "competition for growth" (Zhang et al. 2015), "local government tournaments" and "regionally decentralized authoritarianism", emphasizing how the combination of government structure (vertical decentralization and horizontal competition) and cadre assessment systems affects the incentives of local governments to develop the economy. The "tournament system" theory holds that it is the cadre assessment system and decentralization that trigger development competition among local governments. In this tournament, the superior party committee and government, which wield the power of personnel promotion, are the referees of local governments' performance. That is, local governments at each level are not only the referees of their subordinate units but also candidates participating in the competition themselves (Zhou 2009). Starting from the presupposition of cadre promotion and tournament systems, Chinese and overseas scholars have published a large body of empirical studies based on quantitative analysis to determine which factors are decisive for cadre

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<sup>6</sup> See Zhang (2020) for a comprehensive review of regional models.



promotion. The tournament mechanism theory of cadre promotion holds that under the centralized political system in China, superior supervisors mainly evaluate and select lower-level cadres based on their performance in promoting economic growth. This preference makes lower-level cadres have a strong motivation to develop the economy to obtain political promotion. This tournament system prevents the participants from conspiring with each other, which makes it possible for the mechanism to be effectively implemented. Under certain conditions, including when the participant's risk propensity is indifferent, the tournament can achieve the optimal incentive effect (Zhou 2007). On the one hand, the theory of a "regionally decentralized authoritarian (RDA) system" agrees with the basic viewpoints of the tournament system. On the other hand, this theory also emphasizes the macro-characteristics of China's economic system (Xu 2010), which is different from federalism (political centralization) and the centrally planned economy (market economy).

The literature above underlines the incentive mechanism within the governmental structure but does not pay enough attention to the issue of the government and the market. Regarding this issue, recent studies by Zhou (2017) and Zheng and Huang (2018) provide some perspectives.

Based on the theory of the local government tournament, Zhou (2017) analyzed the interaction mode between the government and market, which he defined as the "officialdom + market" (guanchang+shichang, 官场+市场) model. "Officialdom" refers to the "competition among cadres", that is, local cadres compete with each other in political promotion, which is a horizontal promotion tournament based on economic development. "Market" refers to the competition among enterprises in the economic market. Zhou (2017) further argues that competition among cadres and enterprises and the cross-regional mobility of material capital and human capital make local cadres treat enterprises and talent kindly, which fundamentally restricts the arbitrariness, excessive intervention and discretionary tendency of state power. The fruits of competition among enterprises and industries within the jurisdiction then contribute to the cooperation of officials and entrepreneurs by sending feedback. The "officialdom + market" model shapes the regional economic development strategy and the diversity of industrial policy and growth paths and triggers the learning effect among different jurisdictions.

Zheng and Huang (2018) raised the theory of "market in state". This theory defines economic activities as the internal part of government responsibility. The government takes promoting economic development as its own responsibility while obtaining the legitimacy of rule from it. China has always had a macrostructure consisting of at least three coexisting markets (or three layers of capital): state capital at the top and free private capital, including small and medium-sized enterprises, at the bottom. Within these two poles, there is an intermediate layer where the state cooperates and coordinates with the private sector.<sup>7</sup> The government thus maintains a balance with the market and fulfills its responsibility for economic management via this three-layer capital structure. However, Zheng also argues that the three-layer capital structure and the balance between the state and the market are asymmetrical and difficult to maintain. The coexistence of

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<sup>7</sup> McNally (2012) raised the theory of two-layer market; Naughton and Tsai (2015) also proposed similar argument in their book.

these three layers of capital also determines that the market in China is subject to the rules of state governance and acts as a tool for the state to achieve its goals, especially economic development goals.

### **Towards a typology of government-business relationship**

Both theories, neo-liberalism, which emphasizes the role of the market, and the theory of the developmental state, which emphasizes the role of the state, are based on the same microfoundation, that is, the relationship between the government and enterprises. In his seminar book *Embedded Autonomy*, Evans (1995) distinguishes three kinds of states, developmental, intermediate, and predatory states,<sup>8</sup> which are distinct from each other based on the relationship between the government and the market. Specifically, the typology is developed according to two dimensions: the autonomy of the state (unsullied, qing, 清) and the relationship between the government and enterprises, that is, embeddedness (intimate, qin, 亲).<sup>9</sup> However, Evans does not clarify the intermediate cases. This paper introduces two other subtypes of intermediate states to Evan's typology: regulatory (strong autonomy with weak embeddedness) and collusive state-business relationships (weak autonomy with strong embeddedness). Collusive state-business relationships could be clientelist or cronyism (Kang 2002) if the state is stronger than the business, or they could be captured if the business is stronger.<sup>10</sup> For a developing country, the main challenge is how to avoid becoming a predatory or collusive state and develop into a regulatory state (Table 4).

Collaborative state-business relationships have both strong embeddedness and autonomy, and collusive state-business relationships have strong embeddedness but weak autonomy. Predatory states lack the ability to prevent individual incumbents from pursuing their own goals; therefore, they extract at the expense of society as well as the state (Evans 1995, 12).

The developmental state theory holds that for late-developing countries, the state needs to play an important role in economic development. Johnson summarized four elements of the "Japan model". First, there should be a group of elite bureaucrats with small-scale, low-cost but qualified management capacity. Second, the political system should provide these elite bureaucrats with a sufficient political arena to effectively implement policies. Third, the state should intervene in the economy in a "market-oriented" way. Finally, there should be a guiding organization such as MITI in Japan. This model was attractive to the reformers of the 1990s and was absorbed by them.

While these typologies, along with planned economy, are static, China's economic reform provides an ideal opportunity to study both the transition from planned economy to market economy and the evolution of government-business relationships, therefore for possible further theoretical development.

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<sup>8</sup> The intermediate state has a limited degree of autonomy and embeddedness.

<sup>9</sup> Based on Xi Jinping's terms on the new type of government-business relationship, autonomy is close to a unsullied relationship (清), while embeddedness is close to an intimate relationship (亲). In other words, this new type of government-business relationship is similar to a developmental state model.

<sup>10</sup> For China's failure to build a regulatory state, see Pearson (2005). See Lynette Ong, for a captured government argument for Chinese local government.

**Table 4** Typologies of State-business relationships

		Embeddedness/connectedness	
		Strong	Weak
Autonomy	Strong	Collaborative/developmental	Regulatory state
	Weak	Collusive: clientelism/captured	Predatory state

Source: Revised from Evans's typology in *Embedded Autonomy*

### Strong state capacity as the foundation of development

The operation of the market requires an autonomous state with strong but constrained capacity. Compared with most developing countries, China's economic development benefits from its strong state capacity. Compared with other transitional economies, China's economic development also benefits from the persistence and resilience of the party and state system (Solnick 1996; Walder 2019). Why could the Chinese government build and keep high autonomy and state capacity?

A related question we discussed above is that one of the prerequisites of modern economic development is a powerful state while this powerful state itself may be a source of troubles. For example, the state may exert its power to play a predatory role in the market rather than preserving it (North and Weingast 1989). How can we effectively prevent the power of the state from being used for predatory acts and put power in the cage of the institution? How can politicians focus on enhancing state capacity rather than personal interest or power struggle and therefore undermining state capacity? For these questions, institutionalization is crucial. Only when institutions can provide credible expectation for politicians will they strive to enhance state capacity rather than defend their own power by relying on the clientelist network or various political tricks that would undermine the state capacity and the well-being of the people. The resolution of this problem mainly hinges on the ruling party's ideology commitment and pursuit of performance legitimacy, a more institutional solution still needs to be built.<sup>11</sup>

China's highly autonomous state with strong state capacity is a historical legacy of its revolutionary age. Apart from a few exceptions, without the threat of wars, developing countries are generally frustrated by the problems of unsound bureaucracy and inadequate state capacity. For most of the time between the mid-nineteenth century and the mid-twentieth century, China suffered from foreign invasions and civil wars. CCP led the prolonged conflicts which give rise to a cohesive ruling elite and a powerful and loyal coercive apparatus, and eventually seized power, grew into a strong Leninist party during this period. This leads to the downfall of rival organizations and alternative centers of power, such as armies, churches, and landowners, and helps to inoculate revolutionary regimes against elite defection, military coups, and mass protest—three principal sources of authoritarian breakdown. Despite the impact of the Cultural Revolution, many characteristics of strong political parties were preserved (Levitsky and Way 2022). Recent cross-national study argues that the existence of strong political party organizations can effectively promote economic growth via specific causal mechanisms as follows (Bizzarro et al. 2018).

<sup>11</sup> For institutionalization of Chinese politics, see Nathan (2003), for lack of institutionalization but unstable balance of power, see Fewsmith (2021).





When we refer to this analytical framework, it is obvious that the CCP has most of the characteristics necessary for a powerful party organization. As for the characteristics in the “party organization” part of Table 5, most of them have resulted from the political system reform since the 1980s. The democratization, institutionalization, and standardization of the political system have been effectively improved. Great achievements have been made in democratic elections, democratic decision-making, democratic management, democratic supervision, the rule of law, and political transparency.

As the ruling Party of a huge size country, the CCP has developed an effective nomenklatura system, i.e., the Party committees select and manage officials of any importance, a combination of imperial China practices and Leninist party’s nomenklatura. Under a centralized system without elections to make the officials accountable to the local residents, the Party needs an effective way to motivate and monitor its agents at different levels. The Party committee, with the assistance of the Party’s Organization Department, evaluates the lower level cadres’ performances according to criteria they set, including economic growth, tax revenue, social stability, environmental protection, and population control, and punishes or rewards both economically (bonus) and politically (better opportunity to be promoted). The criteria can be adjusted according to the Party’s political priorities—for example, the CCP has increasingly emphasized social stability and environmental protection since late 2010s.

The performance-oriented cadre evaluation system, associated with a “pressure-based system,” provide the incentives for regional government (Whiting 2001; Xu 2010). In order to achieve the economic “catch-up” plan and meet the targets set by higher level Party and government, the county- and township-level political organizations (the Party and government as the core) assign these targets, which can be measured quantitatively, to lower-level organizations and individuals, asking them to achieve their targets in a given time. Ability to meet these targets will be rewarded or punished both economically and politically. Some of the targets are so important that if one of them is not met, you get vetoed for promotion (*yipiao foujue*) (Rong et al. 1998, 28).

Regarding the characteristics of the “policies” part of Tables 5 and 6, from the perspective of reform objectives, the reform of the decision-making system mainly relies on collective decision-making and modern technological means to realize the democratization and scientificization of decision-making. Based on the content of the reform, the ownership of power should be clarified, and then the authority of decision-making should be rationally allocated horizontally and vertically. Specifically, in the horizontal dimension, it is necessary for the government to gradually decentralize power to the market and society. In the vertical dimension, it is necessary to improve the management mechanism of decentralization from central to local jurisdictions. Second, the operating rules of decision-making power should be standardized, and the decision-making process must be institutionalized and routinized. A series of sound decision-making procedures must be followed, including proposing a goal, formulating a plan, project bidding, expert evaluation, and final project landing to provide an institutional guarantee for the democratization and scientificization of decision-making. Finally, the decision-making supervision mechanism needs to be improved. It is necessary to enhance supervision by multiple subjects from the beginning to the end of the decision-making process as well as its execution to form an organic democratic decision-making system.

**Table 5** How political party organizations promote economic growth

Characteristics and impact mechanisms				
<b>Party Organization</b>	Influence is formally distributed by position (rather than person)	Decision-making procedures are formalized and regularized through clear rules and statutes	Appointment decisions follow formal procedures	
				
<b>Incentives and Capabilities</b>	Establish a relationship of accountability between party leaders and party members	Encourage long time horizons and enhance the party's capacity to solve coordination problems		
				
<b>Policies</b>	Constraints placed on leaders by strong parties	Prioritize productivity-enhancing public goods and services benefitting the wider population	Capable of reaching authoritative decisions on contested matters of public policy and overcoming the opposition of entrenched institutions and economic interests and making decisions stick	Well-positioned to help facilitate effective implementation
				
<b>Responses by Economic Actors</b>	Presence of credible commitment generates a stable economic environment	Broad-based health and education policies have positive effects on economic productivity by virtue of lowering transaction costs and improving human capital	Polities ruled by strong parties should be less susceptible to civil war and political instability more generally	
				
<b>Growth</b>	Governance by strong parties influences economic actors to increase supply in the major input categories identified by economic growth theory			

Source: Bizzarro et al. (2018)

### Historical evolution, governance transition and market craft

In the last 40 years of reform, China's economy has transformed from a planned economy model characterized as "price distortion at the macro level, resource allocation by plan, and deprivation of enterprise autonomy at micro level" to a socialist market economy system.<sup>12</sup> The market has replaced the plan as the main mechanism of economic operation and resource allocation. The role of the government has been changed from the planner and owner to the regulator, owner of SOEs and supervisor. The ownership structure has also transformed from state ownership to the coexistence of multiple ownership, making enterprises gradually become the main market actors. This section will trace the historical development of the reform from three perspectives, including the reform that transformed the plan economy into a market economy, the transformation of government functions and the process by which enterprises got more autonomy. It should be noted that these reform processes are not designed at the beginning of the

<sup>12</sup> This section refers to the following three books: Wu (2018), Zhou (2017), and Li (2008).

**Table 6** Transformation of plan function since the 1980s

	1980–1992	1993–2000	2000–
<b>Making a plan for the overall objectives</b>	Growth of physical output (the plan of materials and overall balance)	“Macroeconomic regulation”; intensive growth; improvement of productivity and living standards; “sustainable growth”	Industrial structure transformation; income redistribution between urban and rural areas; environmental protection; technological innovation; “human resources”
<b>Making a plan for the organization method</b>	Gradual reduction of the administrative means of mandatory plans and resource allocation; Implement of a “guidance” plan for primary consumer goods market; partial liberalization of prices	A “macro” plan to transform into a market-oriented system; reduction of the administrative means of quantitative indicators and resource allocation; opening up the price mechanism	Introduction of new restrictive indicators to regulate local governments’ behavior in environmental protection and land management; division of “main function zones” to make unified plan for local economic development
<b>Industrial policy</b>	Soviet style of management of industrial resources by industrial departments	Revocation of the industrial departments; starting to formulate industrial policies	Popularization of mid- and long-term industrial plans and business policies

Source: Revised from Heilmann (2019)

reform but are formed gradually through continual exploration and adjustment.<sup>13</sup> These processes involve many unintended consequences, while the CCP also adapting to a changing environment (Shambaugh 2008) (Table 6).

### From plan to market

Established in the 1950s, the plan economy accelerated the process of capital accumulation and a catch-up industrialization when China was still an agriculture economy. While the achievements were astonishing, the negative effects of this system gradually arose. These included a lack of incentives and innovation, a “common big rice pot” (daguofan, 大锅饭), and soft budget constraints, which restricted the further development of the economy. The long-term transformation from a planned economy to a market economy is a difficult task that requires many institutional reforms that complement with each other. One of these institutional reforms is price reform, and the other is economic decentralization, especially fiscal decentralization.

At the Central Working Conference before the Third Plenary Session of the Eleventh Central Committee, Deng Xiaoping proposed decentralizing management power to incentivize the state, local governments, enterprises, and workers. At the Third Plenary Session of the Twelfth Central Committee, the “Decision of the Central Committee of the CCP on Economic System Reform” (Zhonggong zhongyang guanyu jingji tizhi gaige de jue ding, 《中共中央关于经济体制改革的决定》) pointed out that “price system reform is the key to the success of the economic system reform”. Based on the principle of the “combination of adjustment and looseness”, the price reform adopts the strategy of incremental reform. It started from the dual-track price system, the coexistence of planned price and market price, which was then followed by letting the market determine the price instead of the plan.

From 1978 to 1983, in accordance with the principle of the “combination of adjustment and looseness”, the following measures were taken. First, unreasonable prices were

<sup>13</sup> Some scholars believe that the economic reform is a political consideration, with the completion of different interests behind it. See Shirk (1993).

significantly adjusted, mainly by reducing the price scissors, i.e. the gap between industrial and agricultural products and increasing the price of means of production. Second, the restriction on the prices of some products was preliminarily loosened, and enterprises were given some extent of independent pricing rights. These measures promoted the development of production and the rationalization of product structure and incentivized the production enthusiasm of enterprises. However, the dual tracks (the plan and market tracks worked together) and the lack of government macro control efforts and means also resulted in problems, including market disorder, inflation, and rampant official corruption. Confronted with the increasingly serious inflation problem in 1988, the central government decided to break through the price barriers, that is, to promote the merger of the dual-track pricing system and realize the complete marketization of prices in a short period of time, especially the prices of means of production. However, this measure was frustrated and quickly suspended.

From 1989 to 1992, the price reform moved on to curb inflation. Some measures were prudently adopted to achieve the smooth merger of the dual-track pricing system and the gradual marketization of commodity prices. The completion of market-oriented price reform enabled the formation of the information transmission mechanism of the market, which effectively provided incentives, reduced transaction costs, promoted the reform of the political system and economic system, and thus promoted economic development. However, market-oriented price reform did not automatically lead to the creation of a national common market. At the same time, many production factor markets were not effectively formed, and further institutional reforms were needed.<sup>14</sup>

As mentioned in the theoretical framework section, fiscal decentralization had an important effect on China's government-market relationship and its evolution. In the 1980s, the reform to "divide the kitchen for meals", which focused on fiscal decentralization, provided local government officials with the residual claim to promote the development of the regional economy, which led to the thriving of township and village enterprises (TVEs), partial disintegration of the plan economy and the formation of local markets. However, divided meals also caused many negative effects, such as the prevalence of local protectionism, nonseparation between the government and enterprises and a sharp decline in the "two proportions" of the central government's tax revenue to the national tax revenue. This decline undermined the central government's macro control capacity, which forced the central government to introduce tax-sharing reform and recentralize fiscal power. While effectively raising the "two proportions", this reform in 1994 also changed the incentive mechanism for local governments. Instead of being keen to establish and operate TVEs, the local government started to launch new development strategies to attract investment in its development zones (Cao and Shi 2009). To a certain extent, this promoted the formation of a market system nationwide and effectively improved the macro control capacity of the government. However, local governments were confronted with the problem of insufficient fiscal resources caused by the tax-sharing reform. This local fiscal difficulty further led to the large-scale debts of local governments, inadequate provision of public services, and excessive dependence on land finance. These consequences forced the further reform of the fiscal system, especially the

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<sup>14</sup> See Weber (2021) for an intellectual history of gradual price reform.

reform of the tax system, by which sustainable economic growth could be guaranteed by institutional impetus.

Although the fiscal decentralization before 1994 contributed to the collapse of the plan economy and economic development, it did not help to form a national common market. In contrast, it led to the prevalence of local protectionism and market segmentation and resulted in a serious shortage of liquidity of production factors and other products. Other negative effects of this decentralization also impeded regional competition and efficient resource allocation while fostering the predatory behavior of the state as well as leading to corruption and rent-seeking. This looked more like market-distorting federalism than market-preserving federalism (Wedeman 2003).

On the one hand, the mobility of production factors and products is a natural attribute. For example, it is difficult for land and minerals to flow in the market. Compared with the light industry and service industry, heavy industry is relatively difficult to move. This mobility changes with the development of technology and transportation. On the other hand, mobility is also an institutional attribute influenced by political and economic factors. Specifically, certain institutions may restrict the mobility of some production factors with strong mobility in natural attributes (Zhang 2021, chapter 3). In terms of the labor force, which is a highly mobile production factor in natural attributes, the household registration system severely restricted people's mobility in the 1980s and trapped people in their place of household registration. Since the late 1980s, with the relaxation of the household registration system implemented by the local governments, there has been a large scale of migrant workers who migrated to another part of the country, which increased the mobility of labor as a production factor (Solinger 2009).

However, inasmuch as the social security system managed by local governments instead of central government, the workers cannot bring their social security fund with them when leaving a province, the mobility of the labor force is currently still very limited. Research shows that when dealing with workers, local governments always follow the logic of capital accumulation that tends to suppress the labor force while not providing or providing inadequate labor security. Based on the consideration of moral legitimacy, the central government has the motivation to provide labor protection and implement labor law (Lee 2007).

Because of the lack of mobility for land, local governments tend to be predatory when aiming at land-related industries. In the 1990s and the beginning of this century, local governments at the grass-roots level in the central region, which mainly depended on agriculture as a source of tax revenue, often levied large amounts of taxes and fees on the peasants, resulting in a large number of social conflicts (Bernstein and Lü 2003). After the central government abolished the agricultural tax, local governments with insufficient fiscal resources began to extract fiscal revenue via land finance (Chen and Chen 2012; Zhou 2012). The direct consequence was that the number of social conflicts caused by land appropriation increased dramatically, which became the biggest source of conflict in current Chinese society.

As mentioned above, in the late 1980s and 1990s, local governments were keen to create and operate enterprises directly, a "local state corporatism" which resulted in a new kind of integration of the government and enterprises (zhengqibufen, 政企不分). One of the negative consequences was local protectionism; the cross-regional circulation of



products and the migration of enterprises were restricted. It was not until the mid-1990s when the central government launched a series of market economic system reforms, especially after the tax-sharing system reform stripped the local government of the right to claim tax surplus and thus weakened its motivation to establish and operate TVEs, that the local government began to change its local economic development strategy. This strategic transformation drove the local government to invite investment rather than run enterprises by itself (Cao and Shi 2009), which removed the restrictions on the flow of products and capital. To attract more investment, local governments also had stronger motivation to rectify the administrative system, reduce the tax burden, eliminate corruption and improve infrastructure to provide a better “business environment”.

For a transitional economy, the local governments’ and citizens’ behaviors are very important, while a strong central government is the prerequisite to promote market-led reform and the formation of a common market.<sup>15</sup> In addition, the Chinese government plays an important role as a “planner”. It is equally important to investigate the transformation of the function of government initiated by the central government and to trace the transformation of enterprises’ behavior patterns. The following parts will introduce these transformations.

#### **The transformation of government function**

The reform of the market economy required a limited government, and the reform of government functions was a key part of China’s political or administration reform. For reform objectives, the reform of government functions requires the establishment of a public administrative system with unified responsibilities and powers, a clear division of labor and well-coordinated operation to build a public service-oriented, accountable, ruled of law, clean and efficient government. In terms of the reform path, there are two main aspects of the functional reform of government institutions. First, regarding the management of economic affairs, the transformation is a change from direct management to a combination of market regulation and macro control, separation enterprise from the government. Second, for the management of social affairs, the transformation is a change from regulation to service with the goal of establishing a service-oriented government. To be more specific, the administrative examination and approval procedures have been greatly simplified, and the official accountability system has been generally implemented. The openness of government affairs and the transparency of government have been gradually improved, as have the policy consultation and assessment system (Yu 2010). After years of reform, China has gradually built a government that is in line with the requirements of the market system.

In the period of the planned economy, the government system was based on the theory and practice of the Soviet Union and was characterized by plan management, highly centralized power and departmental management. In plan management, the state incorporates most of the components of the national economy into the planning track. The central government issues directive planning indicators to local governments or implements indirect plans. In the fiscal area, a system of unified control over income and expenditure (tongshoutongzhi, “统收统支”) was implemented. This paper pays attention to the effects

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<sup>15</sup> The last 20 years of the history of Russia, another economic transition state, also proves this point. See Treisman (1999).

of fiscal decentralization on the reform. In the management of industrial enterprises, especially for large and medium-sized enterprises, the central government set up corresponding ministries and commissions to directly manage state-owned industrial enterprises. Direct top-down control and regulation were carried out via “vertical lines” (tiaotiao, “条条”). Material and funds required for the production of an enterprise were uniformly distributed and allocated by the supervisory ministries and commissions in accordance with the plan. Regarding investment management, investment was managed by the corresponding departments of the central government under unified plans via different “vertical lines”. (In terms of material distribution, the general materials related to the national economy and the people’s livelihood were allocated by the state plan in a balanced manner, that is, the “unified allocation of materials” (tongpeiwuzi “统配物资”). Other special materials were allocated in a balanced manner by the corresponding departments, that is, the “departmental management of materials” (buguanwuzi, “部管物资”). For employment and wage management, the unified arrangement of the government, especially the central government, was underscored. In price management, unified leadership and hierarchical management were implemented (Hou 2003). From 1978 to the 14<sup>th</sup> National Congress of the CCP, China’s economic system was in a transitional period from a product economy to a commodity economy. Accordingly, the all-inclusive government function under the traditional economic system began to change.

After the Third Plenary Session of the Eleventh Central Committee, a series of documents calling for the transformation of government functions was issued by the Central Committee. In October 1984, the Third Plenary Session of the Twelfth Central Committee of the CCP adopted the Decision on the Reform of Economic System (Zhonggong zhongyang guanyu jingji tizhi gaige de jue ding, 《中共中央关于经济体制改革的决定》). For the first time, this decision comprehensively and systematically discussed the issues of the separation of the responsibilities of government and enterprises and transforming the economic functions of the government and established specific settings for the main functions of the government in managing the economy. The institutional reform of the State Council in 1988 and the pilot reform of local institutions after 1989 were conducted with a main focus on the transformation of the economic functions of the government. In 1990, “Recommendations of the Central Committee of the CCP on the Ten-Year Plan for National Economic and Social Development and the Eighth Five-Year Plan” (Zhonggong zhongyang guanyu zhiding guomin jingji he shehui fazhan shiniannian guihua he “bawu” jihua de jianyi, 《中共中央关于制定国民经济和社会发展十年规划和“八五”计划的建议》) was issued. This recommendation noted that the basic direction of the economic system reform in the next ten years was to set up an economic operation mechanism that would combine the plan economy with market regulation in accordance with the requirements of developing a socialist plan commodity economy. The main tasks of economic management for the state include rationally formulating the plans, projects and macrocontrol objectives of national economic development, implementing proper industrial, regional and other economic policies, coordinating major proportional relations and balance, and using economic, legal and administrative means in a comprehensive way to guide and regulate the operation of the economy.

After the Fourteenth National Congress of the CCP, to adapt to the development of the market economy and in accordance with the requirements of the market economy

system, many reforms and explorations were carried out to transform the economic functions of the government. In 1992, the Fourteenth National Congress of the CCP made it clear that the main functions of the government were overall planning, making policies, guiding information, coordinating, providing public services and inspecting and supervising. The “Government Work Report” in 1994 noted that the main functions of the government were to perform macrocontrol, comprehensive coordination, and social management. In 1998, the institutional reform plan of the State Council proposed that the functions of the government should be effectively transformed into macrocontrol, social management, and public services.

To thoroughly implement these decisions, several rounds of administrative reform were launched. In 1982, in line with the reform of the economic system, the first institutional reform of government was carried out. According to the principle of abolishing overlapping institutions and integrating similar institutions, this reform removed and merged many economic management apparatuses, reorganized some of them into economic entities, and enhanced the comprehensive economic coordination departments. In 1988, to meet the requirements of deepening the economic system reform, the government carried out the second round of reform. This reform focused on the transformation of government functions, but economic management departments were still the key field of reform. This reform further enhanced the macroeconomic control departments and simplified and weakened the specialized economic departments. The social management department stayed much the same in this reform.

In 1993, facing the new requirement of the transition from a traditional economic system to a market economy system, the central government launched the third round of reform under the principles of transforming functions, rationalizing relationships, retrenching crews and simplifying administration as well as improving efficiency. The key points of this reform were to enhance the macrocontrol and supervision departments as well as the social management functional departments. Some specialized economic departments were reorganized into industrial management institutes or economic entities. Furthermore, the internal structure of some basic industry departments related to the national economy and people’s livelihood were greatly streamlined so that these departments no longer directly managed the enterprises after the reform. In this institutional reform, the idea of enhancing the social management functional departments was mentioned for the first time. However, when inspecting this reform with regard to its results, the overall layout of the social management departments remained basically unchanged. The fourth round of institutional reform in 1998 was carried out in accordance with a series of principles and the requirements for developing a socialist market economy, such as changing government functions and the separation of government and enterprise.

After rounds of institutional reforms, substantial breakthroughs were made in the transformation of government economic management functions.

- (1) The focus of government functions was shifted from class struggle to economic construction.
- (2) The method of government management was transformed, and the means of economic management were enriched. This had several results. For example, depend-

ence on administrative means was changed to the more comprehensive use of administrative, economic, legal and market means. Direct management was transformed into an indirect management system. Enterprises were no longer directly managed by the government and became the market actor. The macroeconomic control capacity of the government was enhanced (Chen and Song 2007), while microeconomic intervention was limited. Moreover, government administrative examination and approval matters were retrenched, and working methods were improved.

- (3) Administrative authority was divided, and the structure of government administrative power was adjusted.<sup>16</sup> The adjustment of the administrative power structure mainly refers to the adjustment of power relations among different government departments. These include the relations among comprehensive economic departments, between comprehensive economic departments and specialized economic departments, and among noneconomic departments. More importantly, many ministries were streamlined, and much administrative power was delegated in the reform of the State Council in 1998. The management authority of various departments was divided again, involving more than 100 functions and administrative parts. This series of reforms solved a number of problems of long-term unfavorable relations among these departments. In addition, some authority was delegated to the industry associations.

After 1998, the central government implemented several important institutional adjustments to further transform government functions. In 2002, the 16<sup>th</sup> National Congress of the CCP clarified for the first time that there were four main government functions, including regulating the economy, supervising the market, managing society and providing public services. The social functions of the government were underlined. In 2008, the institutional reform emphasized the transformation of functions in two aspects. One of the transformations was to “enhance social management and public services”; while the other was to “loosen the responsibilities of industry management”. At the 17<sup>th</sup> National Congress, the goal of “accelerating the administrative system reform and building a service-oriented government” was underscored.

As Sebastian Heilmann (2019) notes, on the one hand, China reduced most of the administrative departments of industries formed in the period of the plan economy through institutional reform. On the other hand, reform catalyzed the long-term comprehensive planning and coordination of economic, social, scientific, technological and environmental development. Plans comprised long-term comprehensive strategic coordination, resource mobilization serving the priority objectives, and the macroeconomic regulating setting of economic growth objectives. While successfully promoting economic growth by using investment and foreign trade, infrastructure construction, and industrial diversification as well as macroeconomic adaptability, these highly flexible plans also had some limitations. First, long-term goals were subject to emergency short-term goals. Second, these plans lacked a binding mechanism on local governments and enterprises. Third, these plans led to the thriving of interest groups and their privileges both in the market and political fields. Fourth, there was still a lack of consensus on the

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<sup>16</sup> This includes the discussion in this paper on the adjustment of the authority relations among different government levels and the relations among the government and enterprise.

proper border between the government and enterprises. Finally, the repression of personal initiative, which is the source of innovation, still existed.

Corresponding to the reform by the central government, local governments also launched many rounds of institutional reforms to promote the development of the market economy. However, as mentioned above, local governments are always more directly involved in economic management than the central government because of their greater pressure on economic development. To a certain extent, the transformation of government functions promoted the progress of marketization and economic development, but the inadequacy of this transformation was also one of the most important institutional factors that restricted the market from further playing its fundamental role, the land market and Local Government Finance Vehicle (difang zhengfu rongzi pingtai, 地方政府融资平台) are best examples.

### **The rise of enterprises as the market actors**

The market needs a price mechanism for its operation, but the prerequisite of the validity of the price mechanism is that enterprises are independently operated economies and act according to market rules.<sup>17</sup> The main market actors in China include SOEs, private enterprises, foreign-funded enterprises and various joint ventures. These enterprises, especially SOEs, underwent many rounds of major reforms before becoming market actors.

### **Reform the SOEs**

China is a late-developing country, and the SOE system founded after 1949 has played an important role in rapid capital accumulation and industrialization throughout its history. However, the overcentralized plan economy weakened the enthusiasm of SOEs and local governments and led to the low efficiency of enterprises, which pushed the central government to explore how to mobilize their enthusiasm. However, these efforts resulted in the “circulation” of decentralization and recentralization of administrative power between the central and local governments: if it is let alone, it will be in mess, but if it is regulated, stagnation will follow (yifangjiuluan, yishoujiusi, “一放就乱, 一收就死”).

In 1978, guided by the classical idea of “decentralizing power and transferring profits”, some provinces and municipalities began to carry out the pilot project of expanding enterprise autonomy. While introducing the enterprise profit retention system and employee reward system (transferring profits), enterprises were given more authority for production and management, such as authority for managing production, sales, technological transformation, the personnel system and cadres’ appointment and removal. However, due to the absence of a sound restraint system, this decentralization reform resulted in a fiscal deficit caused by the overpayment of bonuses at the micro level and overinvestment at the macro level. Therefore, this reform of decentralizing power and transferring profits was quickly replaced by a “contract plus bonus” economic responsibility system with the obvious features of the “contract system”. This hybrid system was characterized by a contract of profit and deficit and sharing in the increased revenue but resulted in a failure due to the lack of a supportive reform.

<sup>17</sup> The reform of the fiscal and taxation system played an important role in this process. This paper will not further illustrate this; details can be found in Liu and Fu (2018).

From 1983, the central government decided to cease the contract system and implement the profits-to-tax reform nationwide. The first step of the reform was to levy income tax on profitable SOEs, which meant that most of the profits handed in by enterprises in the past were changed to business income tax. After paying income tax, small-scale SOEs are responsible for their own profits or losses. For some enterprises with more profits after tax, some contract fees need to be remitted. For large and medium-sized SOEs, in addition to reasonable interest retention, part of their profits are handed over to the state in the form of incremental contracts, quota contracts, fixed proportions, and regulation taxes. To fix the accompanying problems, the second step of the profits-to-tax reform, which was launched in October 1984, involved changing the former SOEs' fiscal revenue into 11 categories of tax that needed to be handed over to the state. In other words, the coexistence of the tax-profit system was gradually replaced by a system of completely replacing profit delivery with tax payments.

The replacement of profits by taxes settled the distribution relationship between the state and enterprises. While the enterprise system was renovated, this reform led to the establishment of the industrial and commercial tax system, which played an important role in promoting the management of enterprises and the stability of national fiscal revenue. In this way, the interests of the state, enterprises, and workers were well handled, and all parts were mobilized. However, this reform failed to create a fair business environment and provide appropriate economic incentives for enterprises. In addition, the unfair punishment practice of “whip the fast and hard-working” (biaodakuainiu, “鞭打快牛”) based on the “one-household-one-rate” regulatory tax made enterprises lack motivation. Moreover, SOEs were trapped in a serious decline in profits.

In May 1987, the State Council decided to popularize various forms of contract and responsibility systems nationwide and further improved these systems in 1988. This initiative underscored the implementation of enterprise management autonomy and the transformation of enterprise management mechanisms in accordance with the principle of combining responsibility, authority, and benefit. It should be noted that the contract system in 1978 lacked this restraint of “responsibility”. The distribution relationship between the state and enterprises was thus further clarified according to the principle of settling benchmarks, ensuring revenue remission, levying excessive distribution and keeping the additional distribution and self-compensation for losses.

The enterprise reform characterized by the contract system, the delegation of power and the transfer of benefits in the 1970s and 1980s gradually transformed into a renovated idea to change the management mechanism and establish a modern enterprise system after the Fourteenth National Congress in 1992, but the progress was slow. In 1997, as proposed at the Fifteenth National Congress and further clarified at the Fourth Plenary Session of the Central Committee of the CCP, the corporate restructuring of SOEs was more clearly defined. In the mid-1990s, the central government raised the reform strategies of “grasping the big while liberating the small” (zhuadafangxiao, “抓大放小”) and “strategically restructuring the SOEs”. More specifically, for small and medium-sized enterprises, liberation and restructuring were permitted. For large SOEs, strategic restructuring and corporation transformation were adapted to establish a modern enterprise system and improve the corporate governance structure. The State-owned Assets Supervision and Administration Commission (SASAC) was founded, and ownership of

state-owned assets was separated from public administration authority to separate the identity of the government as an owner and a supervisor. In addition, the governmental and social functions of SOEs, including employment security and social security, were stripped to transform them into economic organizations.<sup>18</sup> Furthermore, some SOEs were reorganized and listed to carry out stock transformation. Multiple investors were introduced under the supervision and restriction of the capital market.

After years of reform, SOEs transformed their operating mechanism, improved their efficiency and strengthened their internal governance mechanism, which in turn promoted the improvement of the socialist market economic system and the transformation of government functions. However, there are still some limitations of SOE reform (Chen: Institutional rebound: why reforming China's state-owned enterprises is so difficult, forthcoming).

### ***Development of private enterprises***

After the Cultural Revolution, with the popularization of the household contract responsibility system, some farmers began to engage in rural sideline business. In urban areas and towns facing serious employment pressure, the government started to permit the development of an individual economy. The individual economy has since developed rapidly.<sup>19</sup>

At the Fourth Plenary Session of the 11<sup>th</sup> Central Committee in 1979, it was proposed that “commune-brigade enterprises should have a great development” (shedui qiye yaoyou yige dafazhan “社队企业要有一个大发展”), which was followed by a series of policies intended to guarantee the development of commune-brigade enterprises. In 1984, the No. 4 document of the Central Committee changed the name of commune-brigade enterprises to TVEs, which was a watershed of the rapid development of TVEs. From 1978 to 1992, the total profits and revenues created by TVEs increased by approximately 16 times, from 11 billion yuan to 174.3 billion yuan, and the total profits increased from 9.551 billion yuan to 11.9 billion yuan. With this rapid-scale growth, the nature of TVEs began to change: the proportion of individual and private enterprises increased up to 37% in 1992, while the proportion of primary industry decreased and that of secondary and tertiary industry increased.

The rapid development of TVEs effectively alleviated the problems concerning agriculture, countryside, and farmers and assuaged the short market supplies and the shortage economy of the 1980s. In addition, the development increased national fiscal revenue and created conditions for TVEs as independent producers, which contributed to the building of a socialist market economic system.

In the mid-1990s, with the implementation of tax-sharing reform and the intensification of competition from private and foreign-funded enterprises, collective TVEs began to lose their competitive advantages and were trapped in large-scale losses. Local governments implemented a wave of bankruptcy and privatization of collective enterprises.

<sup>18</sup> Pearson argues that SASAC's capacity of regulating SOEs was inadequate and the initial goal of the reform was not achieved; see Pearson (2005).

<sup>19</sup> However, Xiaoping Deng acknowledged that the development of TVEs was not the result of the Central Committee's intentional initiative at the beginning but instead was the product of allowing farmers to use their initiative after decentralization. He noted that “TVEs accommodate 50% of the rural surplus labor force. This is not the idea we raised, but the innovation of the grass-roots agricultural units and farmers themselves”. See 1993. Selected Works of Deng Xiaoping (Volume 3) (《邓小平文选》), People's Publishing House., p.252.

After this restructuring, TVEs became the market actor and began to regain vitality and benefits.

As Xi Jinping summarized, the private economy has the characteristics of “56,789”: it contributes more than 50% of tax revenue, 60% of GDP, more than 70% of technological innovation achievements, more than 80% of urban labor employment and constitutes more than 90% of the number of enterprises. The private economy has thus become an important engine for China’s economic development.

In sum, after 40 years of exploration and reform, China has transformed from a plan economy into a socialist market economy through top-down propelling and bottom-up innovation. The functions of the government have been changed accordingly. Enterprises have gradually become the main market actor. These reforms have changed the relationship between the government and market and laid the institutional foundation for economic development. Based on the case studies of several counties, Yuanyuan Hong proposed the theory of coevolution of the state and market, which theorizes China’s incremental reform and rapid development.<sup>20</sup> She argues that there are three stages in the coevolution. First, a conventional weak institution is used to build the market. Second, emerging markets are used to trigger strong institutions. Third, a strong institution is used to preserve the market. These three stages are linked via specific channels. This theory not only discusses the formation of the market but also investigates the transformation of government functions, especially how the two sectors coordinate with each other to achieve development, which is helpful for understanding China’s reform. However, this research only considers the county level.

### **Major experiences and strategies**

Based on the theoretical analysis and historical review above, we can identify the following five experiences and development strategies of China’s economic reform and development and the adjustment of the relationship between the government and the market.

#### **Playing the role of the market**

China’s economic development is the product of the continuous exertion of the role of the market. While the market was denied or even banned in the 1970s, it was explicitly proposed that a “commodity economy is an insurmountable stage of social and economic development” and a “socialist economy is a planned commodity economy based on the public ownership system” at the Third Plenary Session of the Twelfth Central Committee in 1984. At the Fourteenth National Congress of the CCP in 1992, it was clarified that the goal of the reform was to establish a socialist market economic system, and the fundamental role of the market in resource allocation under macro-economic regulation was underlined. By the Third Plenary Session of the Eighteenth Central Committee in 2013, it was further proposed that the market played a “critical role” in the allocation of resources, which demonstrated the process by which the power of the market was gradually unleashed. During this period, there were also

<sup>20</sup> Another topic discussed in her book is “adaptive efficiency”, which is divided into three stages: plan formulation, plan selection and the creation of fit in line with local diversity. (Hong 2018) This analysis is similar to Sebastian Heilmann’s argument quoted and explained in this paper (Sebastian 2019). This will be further discussed in this paper.



regulating measures aimed at the market chaos and disorder caused by excessive decentralization.

As a transitional economy, China's market emerged from and grew gradually within the gap of the plan economy, or "growing out of plan", as Barry Naughton notes. Therefore, the following challenges exist in building the market.

First, China needs to regulate the order of market competition, including breaking local separatism and the given industrial structure to find a unified national market and eliminate market discrimination and administrative monopoly. This means that all kinds of market players should be allowed to enter the market equally and obtain production factors equally. Additionally, market rules including fairness, openness and transparency are needed. However, this process is extremely difficult and has not yet been accomplished. There are also still challenges, including local protectionism resulting from fiscal decentralization and ownership discrimination and administrative monopoly caused by privileged policies and a mixture of various ownership systems (Hong 2015).

Second, China needs to improve the market system and promote the flow of factors from inefficient sectors to efficient sectors. On the one hand, the system of the commodity market and the labor market has been gradually improved, which has strongly promoted economic development. Some scholars even believe that the rapid economic growth in China in the first three decades is mainly attributed to the "demographic dividend" produced by the transfer of a large number of rural laborers to the secondary and tertiary industries. On the other hand, it is necessary to promote the establishment and improvement of the factor market, but the construction of the financial market, technology market, talent market, and land market is lagging. The major reason for the unsound financial market and land market is that these two markets have a high degree of correlation with the interest of local governments, which are supposed to be economic construction-oriented governments. This correlation makes local governments lack the motivation to further promote market-oriented reform, which requires a top-down overall plan that motivates them to fix it.

### **Making enterprises the market actors**

The goal of enterprise reform is to build a modern enterprise system that includes the following aspects. First, there is a modern property rights system with unambiguous ownership, a clear distinction between rights and responsibilities, strict protection and smooth supportive operation. Second, there is a corporate governance structure with coordinated operation and effective checks and balances. Third, there is a professional management system that encourages entrepreneurship. This goal was set up in late 1990s as the product of nearly two decades of exploration, and it will take even more time to achieve it.

Enterprises are the main actors under a market economy. However, it is difficult for SOEs that have survived in the planned economy for decades to become market actor, they were confronted with four major obstacles: first, accomplishing the government assigned tasks and policy burdens; second, guaranteeing the secured jobs of workers; third, dealing with serious burdens of performing social functions; and fourth, handling the soft budget constraints. When the state gradually reduced the plan mandates and liberalized prices, enterprises did not automatically become market actors.

Soft budget constraint refers to the tendencies of an economic organization (enterprise or subordinate government) that is not confined to its own resource pool and is able to expect various forms of aid, including additional investment, loans, tax deductions and financial aid from external organizations, especially superior organizations, when trying to survive its own financial deficit crisis. Under soft budget constraints, enterprises tend to borrow, invest and expand excessively, and these investments are inefficient. This results in excessive debt and macroeconomic inflation as well as the failure of national macro control (Lin et al. 2004; Lin and Li 2004). The “iron rice bowl” is a lifelong guarantee for cadres and workers once they are hired, and there is no risk of unemployment regardless of their personal performance. Enterprise-run societies even provide welfare guarantees from birth to death for workers who enjoy “iron rice bowls”.

Confronted with these four obstacles, SOEs could not become independent market actors. It was impossible for them to be subject to regulation and control by market prices, including capital costs, according to the law of supply and demand. It also made it impossible for SOEs to dismiss incompetent employees and employ qualified employees according to business needs. This explains why the contract system and the profit-to-tax reform were not able to effectively solve the problems of SOE reform. SOEs did not become the market actor until their reform in the 1990s.<sup>21</sup>

Initially, collective TVEs were also confronted with the problems of an enterprise-run society and soft budget constraints. Due to the less severe conditions of these problems compared to the same problems for SOEs, TVEs obtained more institutional competitive advantages than SOEs. The close relationship between TVEs and local governments made these enterprises have a better governance structure than SOEs and contributed to their good performance in the early 1980s and 1990s. However, with the development of private enterprises and foreign enterprises and the end of the shortage economy, the institutional problems accompanying this closeness became obstacles to further development, which led to the dilemma of bankruptcy faced by these TVEs and large-scale privatization in the mid-1990s. There are regional variations of the interaction among local enterprises, foreign enterprises and local governments, and variations of success of industry upgrading (Chen 2018).

There were no such institutional problems for private enterprises, which made them the most active market participants and strongly promoted the process of marketization. However, private enterprises were faced with various other problems, such as their small size, institutional discrimination, and barriers to entry into some industries. Moreover, their corporate governance also deviates from family management, which is different from the modern enterprise system.

### **Transformation of the government functions**

Strong state capacity is one of the foundations for the emergence and operation of the market. As a transitional economy, the effective role of the market cannot be separated from the transformation of government functions. To a certain extent, only a limited government can be a strong government.

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<sup>21</sup> Scholars and policy analysts still doubt the extent to which SOEs have become market actors. For example, although plan mandates no longer exist, policy burdens, soft budget constraints and inefficiencies persist; see the joint research group of the World Bank (2013).

Under the “totalism” mode or the traditional state ruling mode, the state dominates society and the economy. The boundaries between the state and society and between the state and the market are ambiguous or even absent (Zou 1994; Scott 1999). This system led to various problems in practice and resulted in the low production efficiency and living standards of the people in China after 1949. Furthermore, it caused the great catastrophe, the Cultural Revolution.<sup>22</sup> With the gradual evolution of the reform, the market was separated from the state, which also challenged the old model of social control and state governance based on the plan economy and unit system.<sup>23</sup> After more than 30 years of reform and economic development, it will be a new challenge for the government to manage society when facing an increasingly pluralistic society. Taking the macrocontrol policy as an example, the adjustment involves three aspects.

First, the object of macroregulation has been transformed from directly giving mandates to enterprises to coping with, managing and regulating the market in the market economy period.

Second, the content of macrocontrol has been changed from direct pricing to controlling the overall level of the market price and the inflation rate and maintaining the order of market competition.

Third, the means of macrocontrol have been changed from the previous plans and indicators to legal and policy tools, including fiscal and monetary policies, industry-related investment and credit policies.

Even so, macrocontrol is still the most effective administrative means. There is still a problem of the effectiveness of monetary and fiscal policy: “if it is let alone, it will be in mess; but if it is regulated, stagnation will follow”.

### **The importance of gradualism**

In terms of the reform path, unlike the shock therapy used by Russia, China adopted incremental reform. The Washington Consensus<sup>24</sup> once dominated the early stage of economic transition, and most countries, including Russia and Eastern European countries, carried out large-scale privatization, marketization and liberalization reforms of their economic systems in accordance with this strategy. Instead of bringing about the expected orderly market transformation and economic growth, “shock therapy”, which aimed to achieve the goal of the Washington Consensus in a short time, resulted in economic disorder, severe inflation and long-term recession in most transitional countries.

As mentioned above, China’s incremental reform adopted a transitional scheme of the two-track price system and strived for steady progress. In ownership reform, a strategy was used to cultivate collective and private enterprises and introduce foreign-funded enterprises outside the system to compete with SOEs. Targeted local privatization reform was gradually promoted to realize the strategic layout adjustment of SOEs. In terms of trade and finance policies, the strategy of incremental opening-up and maintaining the initiative was also adapted. The underlying logic of institutional change

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<sup>22</sup> Regarding socialist political and economic system, see Kornai (1992), Part Two.

<sup>23</sup> In rural areas, this unit system was represented in the form of people’s communes and production brigade systems.

<sup>24</sup> This is a kind of reform that emphasizes the reform of financial discipline and the allocation of resources in the public sector, advocates the liberalization of the financial and trade sectors, insists on relaxing government control over exchange rates, interest rates and foreign investment, and underscores the privatization of SOEs and the protection of private property rights. The main purposes of the reform are to realize liberalization, privatization and marketization. This is a typical economic liberalism consensus. See Williamson (1990), Wang (2016).

behind the incremental reform was induced rather than compulsory institutional transition, which is considered both effective and efficient.

In addition to the incremental procedure of the reform, another feature of incremental reform is that it is a step-by-step process based on the accumulation of experience through pilot experiments and error. This reform process is an reversible process in which breakthroughs are made by considering easier, peripheral and micro issues first and then dealing with difficult, central and macro ones (Zheng 2001; Xu 2000; He 2004). Some scholars define this as “experimental governance”. Under the structure and principle of centralization of power, it is the central government that makes the critical decisions in the process of reform, but the specific route of the reform is, to a large extent, the product of local experimental exploration and local competition. The central government provides policy guidelines and delegates some important authority to the local governments while retaining final discretion. Local governments formulate projects and implement plans according to local conditions and participate in innovative policy experiments. This pattern achieves multilateral interaction between the top and bottom levels. Within these two ends, there are several middle layers available for experience exchange and policy diffusion, which grants the central government flexibility to promote its preferred reform initiative nationwide.<sup>25</sup>

Not only is the reform of the market economy system incremental, but China’s political reform is also a gradual, sustainable, dynamic and balanced incremental process, which ensures that state capacity can be maintained and even enhanced (Solnick 1996). China’s incremental political reform is a process of continuously making various policy choices. The main body of policy for making these choices is individuals or core groups consisting of individuals with their own intentions, judging ability and decision-making authority. Under limited conditions, the advocates of reform do not fully understand the consequences of the reform. Therefore, the reformer must make a rational and stable decision according to realistic goals and leave flexible space to adjust the given decision at any time (Xu 2002). The incremental characteristic of the political system reform ensures the preservation of strong state capacity and guarantees that the central government can handle the pace and progress of the market economic system reform. Yuanyuan Hong argues that China’s transformation process presents three unique patterns. The first pattern is pervasiveness; while being incremental, this reform also leads to some systematic changes. The second pattern is boldness; although officials have unusual entrepreneurship, they are also prone to corruption. The third pattern is uneven development; widespread regional disparities coexist with nationwide prosperity (Hong 2018).

### **Future challenges**

For China, there are two specific particularities of the relationship between the market and government. First, as a developing country, China has experienced a process of rapid industrialization from an agricultural economy. The marketization process of China is also a transition from a small-scale embryonic market to a modern market to a large extent. Second, as an economic transition country, China has experienced a rapid

<sup>25</sup> There is a large body of literature related to this argument; see Heilmann (2019), Hong (2018). In addition, see a literature review by Wang (2006).

transition from a plan economy system to a market economy system. Starting from an embryonic form, the market has grown from the gap of the plan economy by institutional arrangements, such as price dual-track system setting. Market actors mainly comprise SOEs that gradually adapt to market rules through a series of reforms, rapidly growing TVEs, including collective enterprises and private enterprises, and later-entering foreign enterprises.

On the surface, the plan economy system and comprehensive state ownership before the reform and opening-up enabled the state to better control economic resources, but it actually undermined the normal incentive and innovative mechanism and soon resulted in economic stagnation. This made it necessary to enforce the economic reform that separated the government from the enterprise and played the role of the market mechanism, which finally led to the miracle of rapid economic development for more than 30 years. However, most of the problems in current economic development can still be attributed to the ambiguous distinction between the government and enterprise and the failure of the market mechanism to play a fundamental decisive role. On the one hand, various authorities are controlled by the government. Rent-setting and a lack of sufficient autonomy still exist in the system. On the other hand, enterprises fail to become the market actor while being subject to the government and tending to seek clientelist protection rather than equal cooperative relations. Therefore, it is impossible to form Evans's "embedded autonomy" and achieve the co-governance of the state, enterprises and industry associations. To achieve these goals, further government reform and market reform are needed.

Currently, there are three main interrelated challenges for the further development of China's economy:

1. The challenge of the middle-income trap. Few middle-income economies have succeeded in their efforts to enter the high-income country group. In most cases, these countries are stuck in the stagnation of economic growth and are unable to compete with low-income countries in labor wages or rich countries in cutting-edge technology development (World Bank 2007).
2. Challenge of industrial upgrading. Underlying the middle-income trap is the dilemma of industrial upgrading for middle-income countries. This means that they are not able to effectively upgrade their industry from a labor-intensive and resource-intensive system to a technology-intensive system, which makes it impossible for them to occupy high value-added sectors in the global industrial chain. The validity of the industrial policy varies with the shifting dynamics of the international landscape, and the application space is being squeezed, which makes it even more difficult for China to realize industrial upgrading than it is for other East Asian countries.
3. The challenge of the investment-driven growth model and local government debt. In the past decade, China's economic growth has relied heavily on the investment of the government, especially local governments. While greatly improving China's infrastructure and promoting urbanization, this model also results in large-scale local government lending and debt.

In addition, China is facing the challenges of changes in its demographic structure, the fading of demographic dividends and the deteriorating international political and economic environment.

The theory of “partial reform equilibrium” in political economy notes that it is not difficult to carry out the initial state of reform under the condition of limited overall reform due to greater impetus than resistance. However, this may also result in an equilibrium state of resistance that hinders further reform. This equilibrium state formed by partial reform is not easy to break due to the absence of a follow-up impetus. After more than 40 years of reform, China is still confronted with the trap of partial reform equilibrium. This idea is consistent with Yingyi Qian’s argument of the change from reform without losers to reform with losers. The losers of the reform will inevitably resist, impede and even defy the further implementation of the reform.<sup>26</sup> The partial reform equilibrium is now getting more serious because of the recent “state advances and the private (sector) retreats” (国进民退), some foreign observers even doubt that the “party-state capitalism” may block further market reform (Pearson et al. 2023).

Another manifestation of the partial equilibrium of the reform is that the government is still very strong in China and acts as the “restless hand” that takes control of various areas. The development of any aspect of the market depends heavily on the government and is strictly regulated by the government. How can the market play a decisive role in resource allocation? Regarding this question, it is necessary to further promote the administrative system reform, transform government functions, streamline the government, decentralize power, lower the threshold for non SOEs to enter monopolized industries. The resistance to these key parts of the reform mainly comes from the government and SOEs. Therefore, it is urgent to further reform the governmental structure. Fang Cai (2013) pointed out that in light of theoretical progress and economic development practice in various countries, there is a growing consensus that the strategy of better defining “what to do” and “what not to do” by the government should receive more attention rather than the Lewis paradox concerning the questions of doing “more” or “less”. When this basic question is clarified, it is necessary to explore the sub question of “how to do it”. Specifically, the main functions that the government must perform consist of preventing all kinds of monopolies, protecting the fairness and adequacy of market competition, and setting up a social security system and a labor market system. In addition, regarding direct economic activities, the government should mostly regulate macroeconomic operation by using fiscal and monetary policy tools. When implementing industrial policies, the government should try to avoid directly intervening in the economic process or distorting the price of factors of production. The government should also eliminate the discriminatory treatment of different business entities. In sum, the government has an indispensable role in promoting necessary institutional reforms.

Moreover, the further adjustment of intergovernmental relations, especially the relation between the central and local governments, and the proper allocation of fiscal revenue powers and expenditure responsibilities at all levels will lay the institutional foundation for the repositioning of the economic role of local governments.

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<sup>26</sup> Barry Naughton (2016) argues that China is confronted with a paradox of reform and growth.

The deeper challenges may also include further political reform, rather than fiscal and administrative reform, as Deng Xiaoping (1993) remarked at 1986 and warned that “whenever we move a step forward in economic reform, we are made keenly aware of the need to change the political structure. If we fail to do that, we shall be unable to preserve the gains we have made in the economic reform and to build on them, the growth of the productive forces will be stunted and our drive for modernization will be impeded.”

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