

RAPID GROWTH AMID FAILED POLICIES:
MARKET TRANSITION, INDUSTRIAL POLICY, AND THE PARADOXICAL SUCCESS
OF CHINA'S AUTO INDUSTRY

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To the memory of
my late beloved father, Kim Dalsoo
1941–2008

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Table of Contents

Abstract

List of Tables

List of Figures

List of Abbreviations

CHAPTER 1 Introduction

1.1 The Puzzle of Chinese Automotive Industrialization

1.2 Literature Review

1.3 Background: Rapid Growth Amid Failed Policies

1.3.1 Rapid Growth

1.3.2 Failed Policies

1.4 Introducing Market Mechanisms into Transitional China

1.5 State Capitalism and The Chinese Economic Miracle

1.6 Organization of the Dissertation

CHAPTER 2 Framework

2.1 The Temporality of Policy Change in Transitional China

2.2 Industrial Policy and the Building of the Socialist Market Economy

2.3 Configurational Causal Chain of the Argument

2.4 Methods and Data

2.5 Doing Fieldwork in A Highly Competitive Industry

2.5.1 Why Political Economy?

2.5.2 Snowball Sampling

2.5.3 Cross-Checking

CHAPTER 3 Recurrent Government Reshuffling and Its Impacts on Industrial Policy

3.1 Introduction

3.2 Managing Industry: How and By Whom?

3.3 Historical Evolution of Industrial Governance in the Chinese Auto Industry

3.3.1 Emancipating Enterprises from Administrative Shackles, 1982–1993

3.3.2 Building the Socialist Market Economy, 1993–2002

3.3.3 Rise of the Shareholding State, 2003–Present

3.4 Biased Preferences, Organizational Discontinuities, and Industrial Policy Implementation

3.5 Conclusion

CHAPTER 4 Reshaping State-Business Relations and the Emergence of a Dual Industrial Structure

4.1 Introduction

4.2 The Relationship of Public Ownership and Market Mechanisms

4.3 Adjustment of the Public Economy's Industrial Structure

4.4 Embedding Vertical Integration of the Planned Economy and Market Mechanisms

4.5 Implications for Auto Industrial Policy Implementation

- 4.5.1 Opening Up Chances for Non-State Enterprises by Selective Retreat
- 4.5.2 Distorted Incentive Structures of State-Led Corporatization and Financialization
- 4.6 Conclusion

CHAPTER 5 Central-Local Fiscal Restructuring and the Rise of the Local Corporate State

- 5.1 Introduction
- 5.2 Fiscal Reform and the Changing Cost Structure of SOEs
- 5.3 Rise of the Local Corporate State and Diverse Local Government-Business Relations
 - 5.3.1 Growing Leverage of Private Firms Vis-à-vis Local Governments
 - 5.3.2 Transforming Manufacturing SOEs into Investment Companies
 - 5.3.3 Playing with the “Shell Resources”
- 5.4 Emerging Coalitions and Constraints on Auto Industrial Policy Implementation
- 4.5 Conclusion

CHAPTER 6 Uneven Endowments, State Intervention, and Varied Forms of Market Competition: Comparison of the Automobile, Petroleum, and Machinery Industries

- 6.1 Introduction
- 6.2 State Intervention and Market Competition
- 6.3 Case Selection and Analysis Strategy
 - 6.3.1 Case Selection
 - 6.3.2 Analysis Strategy
- 6.4 The Petroleum Industry
- 6.5 The Machinery Industry
- 6.6 Conclusion

CHAPTER 7 Conclusion

- 7.1 Theoretical Implications
- 7.2 Methodological Implications
- 7.3 Chinese State Capitalism

Abstract

This dissertation examines how growth-promoting industrial policies failed to realize policy intentions but nonetheless produced rapid growth. The dissertation study is based on eighteen months of field research in China, during which data were collected from primary archival sources and in-depth interviews. The dissertation argues that even when the functioning of state institutions is deficient, industrial policy in a transitional economy can facilitate rapid growth by relieving the commitment problem and, along with other market institutional reforms, opening up a limited amount of market competition. The study demonstrates how industrial policy as a new mode of macroeconomic management to build the socialist market economy failed amid macro institutional reforms across government organizations, state-business, and central-local relations. Nonetheless, the state's promulgation of industrial policy settled the "credible commitment problem" of doing business in China, while its market institutional reforms freed new types of business actors and local governments to form a coalition that challenged the dominant coalition of actors legitimized by the state. In authoritarian China where legal protection of private property rights is weak, industrial policy indirectly signaled that the central government's whimsical and predatory behaviors would be significantly reduced in the designated industries. In addition to blocking the negative actions of the central government, industrial policy also showed the central government's support for industrial promotion. Since embarking on the socialist market economy, the central government has exercised more consistent macroeconomic control thanks to a consolidated government organization structure, enhanced its fiscal capacity through fiscal reform, and strengthened its control over the central state-owned enterprises (SOEs) as the largest shareholder. Ironically, this strengthened control by the central government unleashed market mechanisms that had been suppressed by the local

governments, eventually enabling expanded market behaviors by local governments, subprovincial local SOEs, and private actors. The rise of market competition between rival coalitions, although limited, in turn had the unintended effect of promoting rapid growth.

Previous literature generally assumes that well-functioning market mechanisms or state institutions are necessary for strong economic growth. Hence, the literature primarily emphasizes exogenous challenges arising from globalization, which would either globalize market mechanisms or weaken state capability. In contrast, this dissertation addresses how the endogenous processes of a transitioning economic system affect development outcomes. The dissertation also provides an empirical understanding of Chinese “state capitalism.” Chinese state capitalism succeeded in making selected state-owned enterprises into mega-enterprises, but these are still far from having an institutionalized and sustainable corporate governance structure. Furthermore, the private actors are tied to the central government to gain recognition as legitimate actors in the industry, while they are financially dependent on local governments. Because the private entrepreneurs in China’s auto industry are bound by two different level of constraints, they tend to be “allies of the state,” rather than posing a threat to the incumbent authoritarian regime.

List of Tables

- Table 1-1.** China's Top 10 Car Companies and Numbers of Sales, 2004–2009 (Sales unit: 1,000)
- Table 1-2.** China's Automobile Imports and Exports, 1991–2010
- Table 1-3.** Number of Automobile Manufacturers in China Classified by Annual Production, 2001–2009
- Table 1-4.** Automotive Industry Concentration Ratios: Four-Country Comparison (%)
- Table 1-5.** Breakdown of the FAW Sales Portfolio, 2004
- Table 1-6.** China's Top 20 Auto Exporting Firms: Performance, and Ownership Type in 2012
- Table 1-7.** Comparing “Transition Orthodoxy” and China's Political Economy
- Table 2-1.** Five-Year Plans, Central Committees of the CCP, and State Council/National People's Congress (NPC) Leadership, 1981–2010
- Table 2-2.** Publications on Industrial Policies by Central State Organizations
- Table 3-1.** Changes in Numbers of Central Ministries, State Council Supervising Special Organizations, and Personnel
- Table 3-2.** Reshuffles of Comprehensive and Specialized Economic Agencies, 1982–2014
- Table 3-3.** Different Features of Management by Government Sector (*Bumen Guanli*) and Management by Industry (*Hangye Guanli*)
- Table 3-4.** Shifting Competition in Industrial Policy and the Auto Industry, 1988–2012
- Table 4-1.** SASAC's New Guidelines for National Economic Control, 2006
- Table 4-2.** Number of Centrally Controlled Enterprises (*Yangqi*), 2005–2013
- Table 4-3.** *Yangqi*: Industries, Numbers, Total Operating Incomes, and Profits in 2010

Table 4-4. Total Number of Automobile Companies, Number of Deficit Companies, and Percentage of Total Output Value and Profit by Ownership Types, 1998, 2002, 2005, and 2011

Table 4-5. Top Managers' Appointments in Nine Central SOEs, 2006

Table 5-1. Breakdown of Local Government Taxes in 1991, 1994, and 2010

Table 5-2. Revenue Assignments between the Central and Provincial Governments

Table 5-3. Formation of Competing Coalitions in the Auto Industry

Table 6-1. Status of Industrial Policy Drafting, Reviewing, and Promulgation

Table 6-2. Investment in Fixed Assets (Excluding Rural Households) by Sector, Jurisdiction of Management, and Holding Type (2012)

Table 6-3. Automotive, Petroleum, and Machinery Industries: Number of Central Veto Players, Level of Central State Control, and Local Governments' Stance towards the Sector

Table 6-4. The Formation of the Three National Oil Corporations

List of Figures

Figure 1-1. Amounts invested in the Chinese automotive industry: Trends and share of total investments, 1986–2010.

Figure 1-2. Percentages of the Chinese automotive industry’s total output values by ownership type for 1998, 2002, 2005, and 2012.

Figure 1-3. Motor vehicle production in China, 1993–2010.

Figure 1-4. Annual car production in several key global markets, 1999–2009.

Figure 1-5. Number of auto assemblers in China, 1980–2010.

Figure 3-1. Management by government sector (*bumen guanli*).

Figure 3-2. Management by shareholding state, 2003–current.

Figure 4-1. Trends of SOE deficit rates (%), 1981–1997.

Figure 4-2. Multilevel corporation system of Chinese state-owned business group.

Figure 5-1. Changes of the “two ratios” before and after the 1994 tax-sharing system.

Figure 5-2. Four major sources of local government taxes, 1991–2009.

List of Abbreviations

AC: administrative corporation 总公司

ACF: advocacy coalition framework

AIP: auto industrial policy

BAIC: Beijing Automotive Industry Corporation 北京汽车集团公司

BDA: Beijing Economic and Technological Development Area 北京经济技术开发区

CAAM: China Association of Automobile Manufacturers 中国汽车工业协会

CASS: Chinese Academy of Social Sciences 中国社会科学院

CATARC: China Automotive Technology and Research Center 中国汽车技术研究中心

CCP: Chinese Communist Party 中国共产党

CNAIA: China National Automotive Industry Alliance 中国汽车工业联合会

CNAIC: China National Automotive Industry Corporation (1982-1987) 中国汽车工业公司

CNAIC: *Zhongguo qiche gongye zonggongsi* (1990-2007) 中国汽车工业总公司

CNOOC: China National Offshore Oil Corporation 中国海洋石油集团公司

CNPC: China National Petroleum Corporation 中国石油天然气集团公司

CPC: China Petrochemical Corporation 中国石油化工集团公司

DMC: Dongfeng Motor Corporation, formerly Second Auto Works 东风汽车集团公司

DRC: Development Research Center of the State Council 国务院发展研究中心

DS: developmental states

EPB: South Korea's Economic Planning Board 경제기획원

EWCC: Enterprises Working Committee of the CCP Central Committee 中共中央企业工作委员会

FAW: First Auto Works 中国第一汽车集团公司

FDI: foreign direct investment

JV: joint venture

LEWC: Large Enterprise Working Committee of the CCP Central Committee 中央大型企业工作委员会

MES: modern enterprise system 现代企业制度

MIIT: Ministry of Industry and Information Technology (2008–current) 工业和信息化部

MITI: Japan’s Ministry of International Trade and Industry 通商産業省

MMB: Ministry of Machine Building 机械工业部

MNC: multinational corporation

MST: Ministry of Science and Technology 科学技术部

MoP: Ministry of Petroleum 石油工业部

NDRC: National Development and Reform Commission (2003–current) 国家发展和改革委员会

NOC: national oil companies

NPC: National People’s Congress 全国人民代表大会

PBOC: People’s Bank of China 中国人民银行

PRC: People’s Republic of China 中华人民共和国

SAIC: Shanghai Automotive Industry Corporation 上海汽车集团公司

SASAC: State-owned Assets Supervision and Administration Commission 国有资产监督管理委员会

SC: State Council 国务院

SCOPSR: State Commission Office for Public Sector Reform 中央机构编制委员会办公室

SCREC: State Commission for Restructuring of the Economic System 国家经济体制改革委员会

SC RES Office: State Council Restructuring Economic System Office 国务院经济体制改革把办公室

SDIC: State Development and Investment Corporation 国家开发投资公司

SDPC: State Development Planning Committee (1998–2003) 国家发展计划委员会

SEC: State Economic Commission (1956-70; 1976-88) 国家经济委员会

SESRC: State Economic System Reform Committee (1982-98) 国家经济体制改革委员会

SETC: State Economy and Trade Commission (1993-2003) 国家经济贸易委员会

SME: socialist market economy 社会主义市场经济

SOE: state-owned enterprise 国有企业

SPC: State Planning Commission (1954–98) 国家计划委员会

TAIC: Tianjin Automotive Industry Corporation Group 天津汽车工业集团

TEDA Tianjin Economic-Technological Development Area 天津经济技术开发区

TVEs: Township and Village Enterprises 乡镇企业

USC: Universities Service Centre for China Studies

WTO: World Trade Organization

CHAPTER 1

Introduction

1.1 The Puzzle of Chinese Automotive Industrialization

When Ford named a Chinese private automaker, Geely, as a preferred Volvo bidder in fall 2009, the news surprised not only Westerners but also many Chinese. Due to China's auto industry policy (AIP), which placed strict controls on market entry, Geely's early endeavors to enter the automobile industry had run aground many times. The industry pariah of a decade earlier now became a super star. Once the news spread, local governments across China began to woo Geely by promising large investments in exchange for the promise to establish auto assembly plants in their areas. Geely, along with many other private and subprovincial auto firms including Chery, BYD, and Changcheng, had entered the auto industry only by breaching the central government's auto industrial policy, but they had then become important growth engines that helped fulfill the AIP's goals.

The major beneficiaries of the auto industrial policy, which are mostly large state-owned enterprises (SOEs), have increasingly relied on their foreign joint venture partners' technology rather than becoming the "national champions" of independent development, production, and sales envisaged by the government. For example, according to the National Audit Office Report on the performance of the First Auto Works (FAW), the oldest auto firm in China, between 2008 and 2010, the proportion of independent research and development (R&D) investment is low; the profitability of its independent brand cars is not strong; and the FAW Group's profits come mainly from the joint venture (JV) subsidiaries (National Audit Office 2012). The performance of the other major beneficiaries of the AIP such as Dongfeng, Shanghai Auto, and Beijing Auto

is virtually identical. Rather than meeting the goals set by the AIP, they largely became parts suppliers for the JVs. This dissertation asks how the central government's growth-promoting industrial policies failed to realize their intentions but nonetheless produced rapid growth outside the scope of the policies.

Although the fact is not widely known in the West, China has been the world's largest automobile producer since 2008. In 1984, in the early period of economic reform, only 5,207 passenger cars were assembled in China. By 2014, the number was 19.9 million—29.45% of the approximately 69 million passenger cars produced in the world that year (OICA 2014). From the late 1980s, and especially after the “socialist market economy” (SME) was officially inaugurated in 1992–1993, China actively pursued state-led industrial policies for several “pillar” industries. The 1994 auto industrial policy was the country's first sector-specific industrial policy. However, despite the auto industry's long history of intense government intervention and exceptionally fast growth, the AIP has been considered one of the worst failures of industrial policy in China (Eun and Lee 2002; Huang 2002; Lu and Feng 2004; Zhao 2003). The auto industry is a powerful symbol of industrial modernization; scholars have called the automobile “the machine that changed the world” and the auto industry the “industry of industries” (Womack, Jones and Roos 2007). It is simply impossible to think about economic modernization in early-twentieth century America, post-World War II Germany and Japan, or late-twentieth century South Korea without the automotive industry.

China's meteoric rise in the global economy over the past few decades has drawn extensive attention worldwide. Not only has China overtaken the United States as the world's largest economy measured by GDP based on purchasing power parity, but it now leads in many important sectors including steel and high-technology exports as well as automobiles.

Scrutinizing the political economy of Chinese automobile industrialization will deepen our understanding of the mechanisms of rapid growth in a transitional economy in the era of neoliberal globalization. This dissertation explores the paradoxical success of China's auto industry amid policy failures by examining how interactions between market transitional reforms and industrial policy have shaped the mode of market competition.

Although this dissertation investigates how market mechanisms have been introduced in transitional China, it is not concerned with evaluating whether the market or the state is more effective at creating rapid growth. The study does not deny market mechanisms' welfare-enhancing functions, but demonstrates that in a transitional country like China, even a failed policy intervention from the state can induce limited market competition by solving a "credible commitment problem."¹ In authoritarian China where legal protection of private property rights is weak, industrial policy indirectly signaled that the central government's whimsical and predatory behaviors would be significantly reduced in the designated industries. In addition to blocking the negative actions of the central government, industrial policy also showed the central government's support for industrial promotion. In neoclassical theory, where Adam Smith's concept of the Economic Man, who has the innate "propensity to truck, barter and exchange one thing for another" is dominant, the retreat of the state from economic action is the solution that guarantees the proper functioning of market mechanisms. Led by Karl Polanyi (2001 [1944]),

¹ In their classical study on "credible commitment problem," North and Weingast (1989, 808) succinctly present why the incumbent regime should be committed or bound by rules they made for economic growth to occur. They stress "This article focuses on political factors underpinning economic growth and the development of markets—not simply the rules governing economic exchange, but also the institutions governing how these rules are enforced and how they may be changed. A critical factor is the degree to which the regime or sovereign is committed to or bound by these rules. Rules the sovereign can readily revise differ significantly in their implications for performance from exactly the same rules when not subject to revision. The more like it is that the sovereign will alter property rights for his or her own benefit, the lower the expected returns from investment and the lower in turn the incentive to invest. For economic growth to occur the sovereign or government must not merely establish the relevant set of rights, but must make a credible commitment to them." For a review about how authoritarian regimes overcome commitment problem, see Zheng 2014, 195–197.

however, many institutional scholars have thoroughly researched the possibility of complementary relations between the state and the market (Fligstein 2001; Vogel 1996). Much of the resulting work has considered the developmental state to be the answer to the question of how government intervention contributes to growth; in this literature, well-functioning state institutions are assumed to be a necessary condition for high growth.² On this view, state intervention is conducive to high growth only when the state's macro and micro institutions are at work and lead to disciplined competition between private business actors in a coordinated market (Amsden 1989; Evans 1995; Johnson 1982; Wade 1990). In the case of the Chinese auto industry, however, state intervention through industrial policy seriously failed, because industrial policy as a new tool of macroeconomic control was implemented in tandem with macro institutional reforms. Although these consecutive institutional reforms across government organizations, state-business, and central-local relations were not mature enough to effectively implement the AIP, the result was greatly increased autonomy for firms and local governments. This dissertation argues that even when the functioning of state institutions is deficient, industrial policy in a transitional economy can facilitate rapid growth by relieving the commitment problem and, along with other market institutional reforms, open up a limited amount of market competition.

“Industrial policy” in this dissertation is limited to policies that are issued by the central government with proactive intentions towards certain sectors. Similar to industrial policies in Japan and South Korea, the AIP in China aimed at consolidating the fragmented auto industry both through enforcing entry control *ex ante* and through promoting capacity reorganization *ex post facto*. Even after three decades of rationalization attempts, China still has around 120 auto assembly firms. The majority of them are operating far below the optimal level for economy of

² For a comprehensive review of institutions and growth in East Asia, see Haggard 2004.

scale. As a noted China scholar Yasheng Huang (2002, 539) said, the Chinese auto industry is “among the most fragmented in the world.” Along with strong entry control, the AIP also gave preferential treatment to a small number of designated state-owned enterprises (SOEs) to nurture their transformation into internationally competitive “national champions.” China also pursued a “go-it-alone strategy” just as South Korea did initially, but this strategy was not effective in creating competitiveness and overcoming industry fragmentation. The stagnation of domestic auto development pushed a high demand for foreign passenger vehicles, which created significant pressure on the balance of payments and eventually fueled massive smuggling, especially during the early 1980s (Harwit 1995, 26–33). In this situation, import substitution strategy through the formation of joint ventures with global automobile companies became the basis of the AIP. The establishment of joint ventures (JVs) with multinational corporations (MNCs) was intended as an instrument to consolidate China’s auto sector while a small number of designated SOEs were expected to enhance their international competitiveness to become the hoped-for national champions.

Chinese-style auto industrial policy, however, led to mixed results. As a whole, the auto market avoided encroachment by imported vehicles, but the central state’s intervention inflated automobile prices, which subsequently stimulated various new actors seeking high profit rates to enter the auto sector. Localization requirements intended to achieve import substitution increased local parts production dramatically, but also drove China’s major auto enterprises into focusing on developing parts supplies instead of developing independent models. Large SOEs that received massive benefits from preferential policies reaped profits from the JVs but remained far from realizing the goals set by the AIP. Meanwhile, various new actors were able to enter the auto industry by purchasing nontransferable “production licenses” from small and medium SOEs

that had spun off from other SOEs during the government-led transition to the socialist market economy. Ironically, the designated large SOEs that enjoyed preferential policies degenerated into parts producers for their JV partners, but the fledging domestic actors that violated industrial policy to access the lucrative auto sector eventually became important forces in export with their own brands. In other words, growth-promoting industrial policies failed to realize policy intentions but nonetheless produced rapid industrialization, although it took place outside the scope of the policies.

1.2 Literature Review

Previous literature tackles the puzzle of China's paradoxical success in auto industrialization by taking one of two main approaches. The first approach denies the policy failures, considering policy implementation a "learning process." For instance, Chu (2011, 1267) argued that the AIP was ineffective at first, but China's central state has continued to improve it, adjusting the policy in response to local feedback. By emphasizing the improvement in policy quality over time, Chu implied that the Chinese government has been the primary engine of the auto industry's fast growth. The problem with this explanation is that no matter how much better the central government has become at producing high-quality policy, the AIP is not a "proactive" but a "follow-up" industrial policy. New versions of the AIP have followed the industry's performance, rather than leading the direction of development. The one salient feature of the industrial policy has been the deliberately setting prices wrong to draw excess investment that is then channeled to targeted sectors or firms. Because government selection necessarily resulted in winners and losers, strong state institutions that make the winners comply with the rules and keep the losers away from the targeted sectors are necessary (Amsden 1989). Yet this kind of monitoring

capacity is precisely what the Chinese AIP lacks.³ Furthermore, the critical test of strong state institutional capacity is whether the government maintains autonomy by insulating itself from pressures from vested interest groups (Haggard and Moon 1990). The Chinese central state has not been able to maintain such autonomy, but has been vulnerable to lobbies from central ministries and local states. (Kennedy 2005) For example, six companies were selected as sedan producers in a “big three and small three” scheme in the late 1980s. Later on, however, organizations previously engaged in the defense industry, such as the China Ordnance Industry Corporation and the Guizhou Aviation Industry Corporation, also obtained sedan production permission. They were able to do so because fierce lobbying by the defense ministries and local states had seriously undermined the central government’s capacity to tightly maintain market entry control (Chu 2011; Ngo 2008).

The second approach acknowledges China’s industrial policy failures. This school of thought suggests that institutional constraints such as “divided and decentralized bureaucratic arrangements” (Huang 2002), a “unique central-local government relationship” (Eun and Lee 2002), “large information asymmetries,” and rampant corruption (Fuller 2016) impede effective industrial policy implementation in China. A study of variations in local auto industrial development across four different Chinese provinces (Thun 2006) applied a similar institutional logic. Huang’s (2002) study employed a comparative method to identify the most important institutional foundations that can explain the varying economic performances of China and South Korea, but directly linking institutions to economic performance can easily lead to the fallacy of second-order causation (Moon and Prasad 1994).

³ The literature on China’s industrial policy demonstrates that the Chinese state does not monitor firms effectively (Huang 2003; Moore 2002; Perkins 2001).

Instead of essentializing institutional characteristics and treating certain institutional aspects as a recipe that leads to an inevitable outcome,⁴ this dissertation considers institutions as “both a product of particular political coalitions and a structural force in reproducing particular patterns of political life over time” (Gingrich 2015, 76). While the developmental state literature tends to give more attention to the role of particular institutions in rapid economic growth (Johnson 1982), the welfare state literature considers the variation among welfare states as the outcome of different political processes in given societies (Esping-Andersen 1990). Confronting the paradoxical growth of China’s auto industry, I apply the political process approach that dominates the welfare state research to a question usually raised in developmental state literature. By taking political process seriously, this dissertation explicates how other macro institutional reforms that accompanied China’s implementation of the socialist market economy—central government reshuffles, central-local fiscal reforms, state-business relations—interacted with the AIP. The political process framework does not posit deterministic theories, however. Rather, it demonstrates how parts of institutions shape the scope of the political struggles that give form to economic life (Moon and Prasad 1994, 377–378). This framework opens analytical and empirical spaces for real politics, but the real stories of political struggles are contingent on the actors’ choices under institutional constraints.

1.3 Background: Rapid Growth amid Failed Policies

After the decision to establish a socialist market economy had been adopted at the third plenary session of the 14th Chinese Communist Party (CCP) Central Committee on November 14, 1993,

⁴ Gore (2014) claimed that “laundry list method,” of which enumerate institutional characters, is the culprit of failure of applying developmental state concept outside of its origin countries. Furthermore, Haggard (2014) argued that the strong domestic institutions that is claimed to be necessary for fast economic growth are usually lacking in developing countries. If certain institutional factors are sufficient conditions for economic growth, then most developing countries who lacks these factors should remain in underdeveloped for good.

the State Council issued “Guidelines for National Industrial Policy during the 1990s” in April of 1994. As a new macroeconomic tool, industrial policy targeted both agriculture and industry, but gave initial attention to a few “pillar” industries, such as machines, electronics, chemical and petroleum, auto manufacturing, and construction. The State Planning Commission (SPC) promulgated China’s first sector-specific industrial policy on February 19, 1994. In addition to this particular policy, which has the official title of “industrial policy” (*chanye zhengce*), the Chinese central government, especially in the capacity of the State Council, irregularly announces notices (*tongzi*) or decisions (*jueding*) on the auto industry. Additionally, the State Council regularly issues five-year plans or programs,⁵ each of which also has a particular program for individual sectors. In the most limited sense, the auto industrial policy only includes two policy statements: the SPC’s “1994 Auto Industrial Policy” and the National Development and Reform Commission’s (NDRC) “2004 Auto Industry Development Policy.” Although these are the two most significant statements, auto industrial policy overall is manifested through all of the diverse forms mentioned above (Anderson 2012, ch. 3).

At the beginning of the period of reform, increased auto imports were creating significant pressure on the balance of payments. The primary goal of the auto industrial policy initially was import substitution through the technical upgrading of a small number of large SOEs. A large potential domestic market is one of China’s great assets; hence, the Chinese state devised its AIP by combining import substitution with the establishment of joint ventures, and justified this strategy as “grant[ing] access to the domestic market in return for capital and technology” (*yi shichang huan jishu*; Liu and Yeung 2008, 527). By establishing joint ventures with

⁵ From the 11th Five-Year Program (11-5 program), the term “plan” (*jihua*), which connotes imperative targets, is replaced by the term “program” (*guihua*), which has nonimperative and indicative nuances. Besides the weaker level of obligation, programs from the 11-5 program on are intended to include not only economic policies, but social policies (“Tenth Five-Year Plan of the CCP Central Committee on National Economic and Social Development,” 2005, adopted at the fifth plenary session of the 16th CCP Central Committee).

multinational corporations, the designated SOEs were expected to develop into internationally competitive companies. The JV-based auto industrial policy, however, led to mixed results. As a whole, the auto market avoided encroachment by imported vehicles, but this inflated automobile prices. Local governments' localization requirements increased local parts production dramatically, but this also drove China's major auto enterprises into focusing on developing as parts suppliers instead of developing independent models. By 2005, after a decade of Chinese-style industrial policy, there were "28 separate joint ventures and wholly Chinese owned firms producing more than 120 models, with an average annual volume per model of fewer than 30,000 units" (Noble, Ravenhill, and Doner 2005, 21). If we consider the minimum efficient scale, customarily fixed at 250,000 units per year for a single production run, the rationalization process still had a long way to go.

China finally entered the World Trade Organization (WTO) in 2001 after 15 years of haggling. Due to sharp reductions in tariffs and bans in some industrial policy measures, there were many worries about the auto industry (Harwit 2001; Noble, Ravenhill, and Doner 2005). Harwit (2001, 669) suggested three different scenarios for the impacts of the WTO on China's auto industry. In the worst case, the Chinese markets would be swamped by imports and a series of bankruptcies would follow. The middle scenario was that the industry might maintain the status quo. The best case would be that domestic companies would overcome the challenges of WTO membership and rise to compete by producing world-class vehicles. The current situation, more than 10 years after China entered the WTO, is somewhere in between the middle and best case scenarios. While large SOEs remain the major partners of foreign multinational auto companies, newly emerging indigenous actors have started to increase their market shares, especially for low and middle price cars.

Figure 1-1 demonstrates investment trends in the automotive industry and its shares in total investments in the period of 1986–2010. Total net amounts invested in the auto industry have gone up. The industry’s share of total investments shows two humps, around 1994 and 2004, the years that formal AIPs were issued. As the figure shows, the positive effects of these AIPs on investments did not last long. Furthermore, the effect of the second AIP on investment in the auto industry was smaller than that of the first.

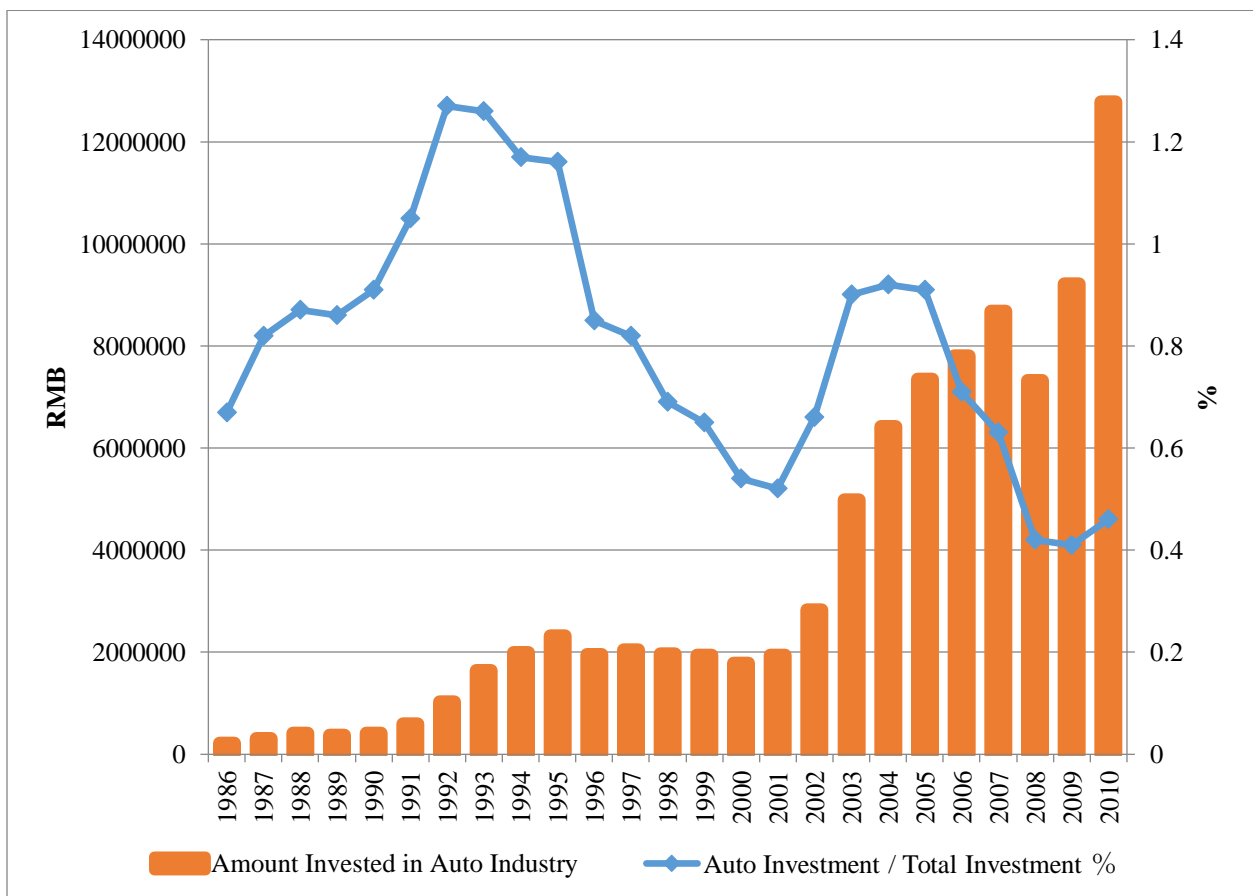


Figure 1-1. Amounts invested in the Chinese automotive industry: Trends and share of total investments, 1986–2010.

Source: *China Automotive Industry Yearbook 2011* (2011, 13).

Table 1-1 and Figure 1-2 below demonstrate the binary structure of the automotive industry in China. Table 1-1 shows the country’s top 10 passenger vehicle companies and their

sales volume between 2004 and 2009. The top three, all JVs between SOEs and MNCs, did not change over this period. Despite these companies' firm hold on their top-three status, late-coming JVs and indigenous brands engaged in a heated competition to rank in the next highest positions. Three domestic makers, Chery, Geely, and BYD, made huge advances during the same period. Figure 1-2 also shows sedan market shares of output values by ownership type. State-ownership and JVs, the two dominant ownership types, prevail with 60% of the total output value, although this is a decrease from 75% in 1998. Despite the headway made by private companies in sales volume shown in Table 1-1, their output values reached less than 3% in 2011.

Table 1-1. China's Top 10 Car Companies and Numbers of Sales, 2004–2009 (Sales unit: 1,000)

| | 2004 | | 2005 | | 2006 | | 2007 | | 2008 | | 2009 | |
|----|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | <i>Maker</i> | <i>Sales</i> | <i>Maker</i> | <i>Sales</i> | <i>Maker</i> | <i>Sales</i> | <i>Maker</i> | <i>Sales</i> | <i>Maker</i> | <i>Sales</i> | <i>Maker</i> | <i>Sales</i> |
| 1 | S-VW | 354 | S-GM | 298 | S-GM | 413 | S-GM | 500 | F-VW | 499 | S-VW | 728 |
| 2 | F-VW | 300 | S-VW | 245 | S-VW | 352 | F-VW | 456 | S-VW | 490 | S-GM | 708 |
| 3 | S-GM | 223.8 | F-VW | 238 | F-VW | 345 | S-VW | 436 | S-GM | 455 | F-VW | 669 |
| 4 | G-Honda | 185 | B-Hyundai | 234 | Chery | 305 | Chery | 381 | F-Toyota | 366 | B-Hyundai | 570 |
| 5 | B-Hyundai | 144 | G-Honda | 203 | B-Hyundai | 290 | G-Honda | 295 | Chery | 356 | D-Nissan | 519 |
| 6 | Charade | 130 | Charade | 190 | G-Honda | 260 | F-Toyota | 281 | D-Nissan | 351 | Chery | 484 |
| 7 | C-Suzuki | 110 | Chery | 189 | F-Toyota | 223 | D-Nissan | 272 | G-Honda | 306 | BYD | 448 |
| 8 | Chery | 93 | D-Nissan | 158 | Geely | 204 | B-Hyundai | 231 | B-Hyundai | 295 | F-Toyota | 417 |
| 9 | D-PSA | 89 | Geely | 149 | D-Nissan | 203 | C-Ford | 218 | Geely | 222 | G-Honda | 365 |
| 10 | Geely | 87 | D-PSA | 140 | D-PSA | 201 | Geely | 218 | C-Ford | 205 | Geely | 329 |

Source: Hyundai Motors Co. (cited in Kim 2010, 130).

Note: B-Hyundai (Beijing Hyundai), C-Ford (Chang'an Ford), C-Suzuki (Chang'an Suzuki), D-Nissan (Dongfeng Nissan), D-PSA (Dongfeng Peugeot Citroen), F-VW (First Volkswagen), F-Toyota (First Toyota), G-Honda (Guangzhou Honda), S-GM (Shanghai GM), S-VW (Shanghai Volkswagen).

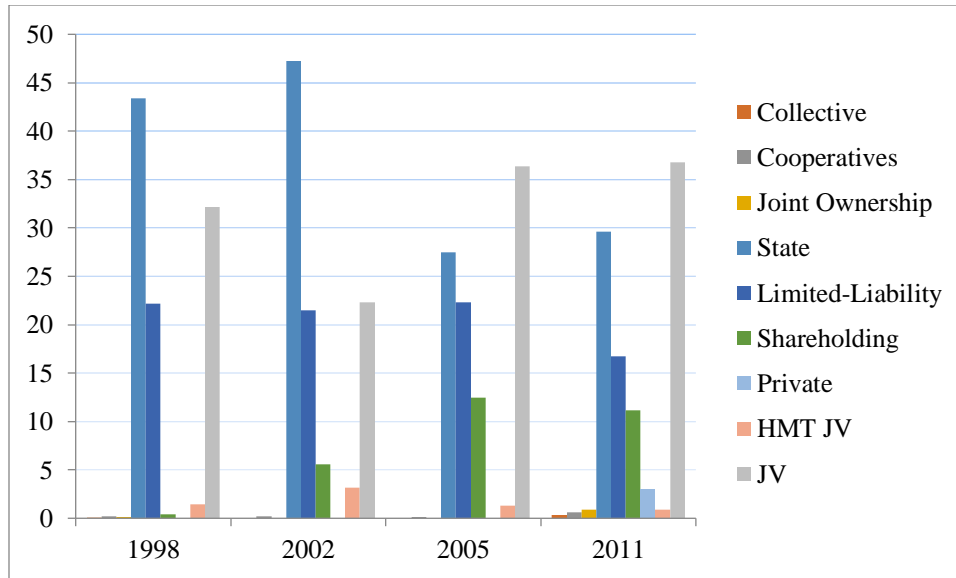


Figure 1-2. Percentages of the Chinese automotive industry’s total output values by ownership type for 1998, 2002, 2005, and 2012.

Source: Compiled by author from the *China Automotive Industry Yearbook* (China Automotive Technology and Research Center [CATARC] 1999, 2006, 2011).

Note: Ownership types: (1) Domestically funded corporations: state-owned (*guoyou*), collective-owned (*jiti*), shareholding cooperatives (*gufen hezuo*), joint ownership (*lianying*), limited liability corporations (*youxian zeren gongsi*), limited shareholding corporations (*gufen youxian gongsi*), private (*siying*); (2) HMT JVs: corporations with funds from Hong Kong, Macao, and Taiwan (*Gang Ao Taishanng touzi gongsi*); (3) JV: foreign funded enterprises (*waishang touzi qiye*).

1.3.1 Rapid Growth

China’s auto industry has recorded unprecedented high growth over the last two decades. Despite the long history of automotive manufacturing in China (Harwit 1994, 15–42; Editorial Office of History of China Automotive Industry 1996), the industry took off only very recently. In 1978, at the beginning of Chinese economic reform, the total number of automobiles produced was only 149,062. During the first decade of the economic reform, the industry grew, but at a slow pace. As Figure 1-3 shows, the growth rate has accelerated since the beginning of the new century. China’s total car production including cars and commercial vehicles exceeded 20 million units in 2014 and, as Figure 1-4 demonstrates, China surpassed Japan to become the world’s largest

automobile manufacturing country since 2009. The majority of the cars are still consumed in the Chinese domestic market, but the number and amount of automobile exports has recently started to grow. The total volume and amount of exports finally surpassed those of imports in 2005, although the gap is still small and dwindles almost to nothing from time to time. It is a remarkable achievement: only 20 years ago, in 1985, China imported 353,992 vehicles and exported 1,659. The number of imported products was equivalent to 79.8% of domestic products (total 443,377 units) in the same year. The Chinese auto industry was on the edge of encroachment by imports in the 1980s, but within two decades, China had started to export its own cars, albeit most are low-end products headed to developing markets. (See Table 1-2.)

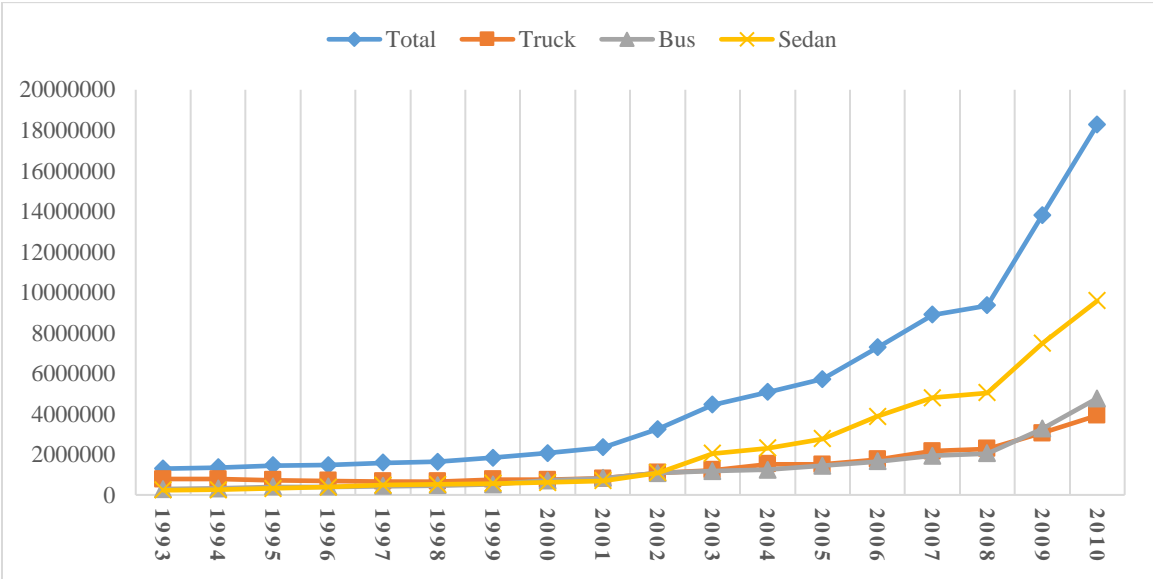


Figure 1-3. Motor vehicle production in China, 1993–2010.
Source: China Automotive Industry Yearbook 2011.

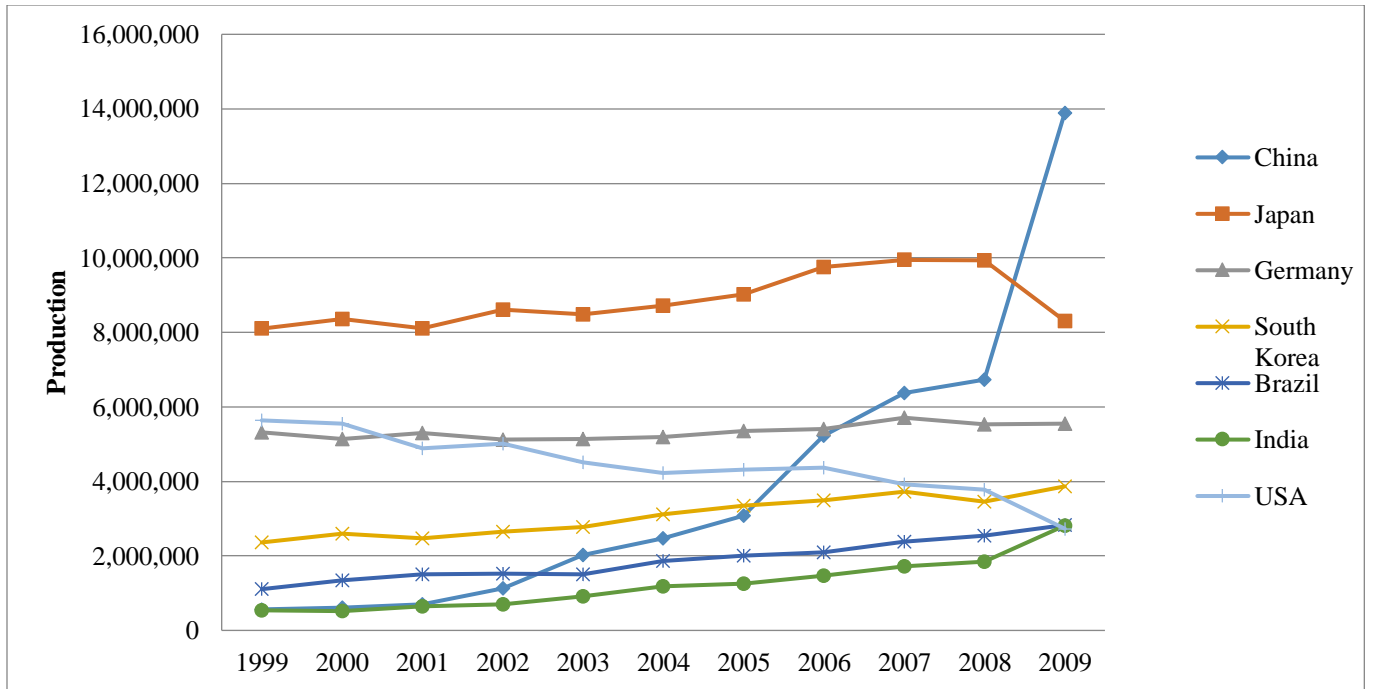


Figure 1-4. Annual car production in several key global markets, 1999–2009.
Source: OICA Respondent Surveys (1999–2009).

Table 1-2. China’s Automobile Imports and Exports, 1991–2010

| Year | Imports | | Exports | |
|------|---------|---------------------------|---------|---------------------------|
| | Number | Amount (10,000 USD) | Number | Amount (10,000 USD) |
| 1991 | 98454 | 165992 | - | - |
| 1992 | 210087 | 353523 | - | - |
| 1993 | 310099 | 535143 | - | - |
| 1994 | 283060 | 471482 | - | - |
| 1995 | 158115 | 257549 | - | - |
| 1996 | 75863 | 250018 | - | - |
| 1997 | 49039 | 207821 | 14868 | 98784 |
| 1998 | 40216 | 205789 | 13267 | 88343 |
| 1999 | 35192 | 258018 | 10095 | 118727 |
| 2000 | 42703 | 404750 | 27136 | 247854 |
| 2001 | 71398 | 470326 | 26073 | 271227 |
| 2002 | 127513 | 659985 | 21960 | 335890 |
| 2003 | 171710 | 1483964 | 45777 | 802642 |
| 2004 | 175480 | 1686001 | 75999 | 1241912 |
| 2005 | 161324 | 1543392 | 164258 | 1677028 |
| 2006 | 227773 | 2127410 | 343379 | 2890961 |
| 2007 | 314130 | 2676775 | 614412 | 4126332 |
| 2008 | 409769 | 3222993 | 681008 | 4762503 |
| 2009 | 420696 | 3419834 | 370030 | 3835151 |
| 2010 | 813345 | 5817052 | 566653 | 5413927 |
| 2011 | 1038622 | 5598518 | 849808 | 7196508 |

Source: *History of China’s Automotive Industry 1991–2010* (2014, 401–402).

1.3.2 Failed Policies

Although the growth of China’s auto industry is impressive, it was realized completely outside of the government’s policy intentions. The Chinese government has implemented various policies designed to protect the industry since the 1980s with the goal of enabling the auto industry to establish itself as an important pillar industry (*zhizhu canye*) in the Chinese national economy. The SPC’s “1994 Auto Industrial Policy” (“Qiche gongye changye zhengce”)⁶ was the first sector-specific industrial policy in statutory form. The NDRC’s “2004 Auto Industry

⁶ The full text in Chinese is available at <http://www.china.com.cn/chinese/zhuanti/fbss/583597.htm>

Development Policy” (“Qiche gongye fazhan zhengce”)⁷ was intended to help the industry accommodate the new policy environment that would accompany China’s entry into the WTO on 11 December 2001. While the details of the policy have changed, the ultimate goal of making the Chinese auto industry big and strong has remained consistent. Two specific characteristics commonly shared by advanced auto manufacturing countries have been the main objectives. The first was to set up the auto industry to realize economies of scale. According to the 1994 AIP, the Chinese auto industry had fallen ill with “scattered investment (*san*); disordered project approval (*luan*); overlapping imports of low-level products (*di*); and slow construction of designated plants and technology localization phase (*man*).” To remedy these problems, the auto industrial policy intended to strictly control market entry and foreign direct investment and to promote the designated auto manufacturers to form large business groups. The second goal was to participate in international competition through promoting independent development (*zhizhu kaifa*), production, and sales. The 1994 AIP anticipated that the designated auto manufacturers would build their capacity for independent innovation, which would lead to them exporting cars with their own intellectual property rights and brands.

After more than two decades, even though China has become the world’s largest automobile manufacturing country, the majority of Chinese auto firms are far from reaching even the minimum economy of scale (MES), which, in automobile manufacturing, is “around 250,000 units at the plant level and for a single basic model type” (Huang 2002, 543). The AIP prioritized industrial consolidation, but as Figure 1-5 demonstrates, according to the data reported in the *China Automotive Industry Yearbook*, the total number of auto assemblers has stabilized at around 120. The internal data collected by the China Automotive Technology and Research Center (CATARC), however, revealed that the number of auto firms that assembled more than

⁷ Full Chinese text is available at http://www.sdpc.gov.cn/zcfb/zcfbl/200506/t20050614_7501.html

one vehicle was much larger than the official number reported in the *Yearbook* (Marukawa 2013). As shown in Table 1-3, even in 2009, the year that China became the world’s largest manufacturer of autos, the average number of units produced was 98,016, still less than half needed for the MES. Only 25 firms out of the total 145 produced more than 200,000 vehicles. The number of loss-making firms has been continuously declined, but even in 2009, 39 firms out of the total 145 (about 37 per cent) are operating in deficit.

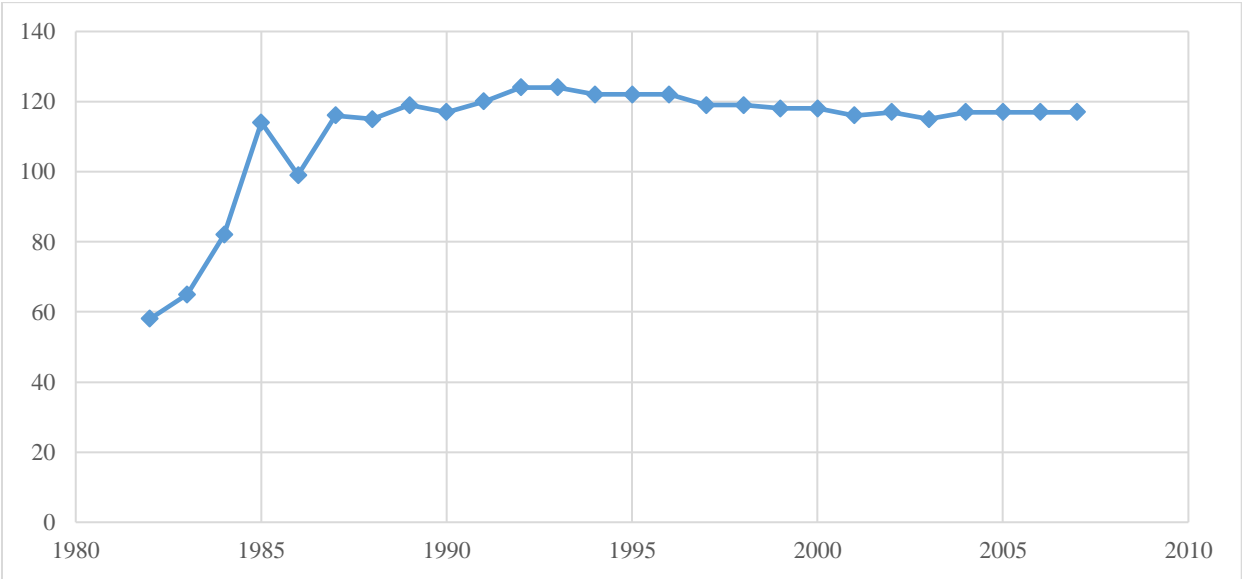


Figure 1-5. Number of auto assemblers in China, 1980–2010.

Table 1-3. Number of Automobile Manufacturers in China Classified by Annual Production, 2001–2009

| Year | 2001 | | 2003 | | 2005 | | 2006 | | 2007 | | 2008 | | 2009 | |
|--------------------------|--------------|--------------------|--------------|--------------------|--------------|--------------------|--------------|--------------------|--------------|--------------------|--------------|--------------------|--------------|--------------------|
| Annual production volume | No. of firms | No. of loss-makers | No. of firms | No. of loss-makers | No. of firms | No. of loss-makers | No. of firms | No. of loss-makers | No. of firms | No. of loss-makers | No. of firms | No. of loss-makers | No. of firms | No. of loss-makers |
| < 100 | 15 | 12 | 13 | 7 | 7 | 4 | 7 | 5 | 8 | 3 | 6 | 2 | 6 | 3 |
| 101–1,000 | 38 | 22 | 34 | 14 | 32 | 17 | 28 | 17 | 22 | 10 | 19 | 11 | 14 | 7 |
| 1,001–5,000 | 30 | 14 | 33 | 15 | 32 | 19 | 25 | 11 | 29 | 10 | 28 | 8 | 28 | 11 |
| 5,001–10,000 | 18 | 8 | 13 | 4 | 12 | 5 | 13 | 3 | 8 | 4 | 12 | 5 | 13 | 5 |
| 10,001–50,000 | 15 | 2 | 23 | 2 | 32 | 7 | 37 | 8 | 44 | 9 | 41 | 10 | 30 | 5 |
| 50,001–100,000 | 11 | 2 | 10 | 0 | 9 | 2 | 15 | 0 | 8 | 1 | 12 | 2 | 12 | 3 |
| 100,001–200,000 | 4 | 0 | 9 | 1 | 13 | 4 | 10 | 2 | 17 | 2 | 18 | 1 | 17 | 3 |
| > 200,000 | 4 | 0 | 7 | 0 | 10 | 1 | 18 | 0 | 19 | 0 | 18 | 0 | 25 | 2 |
| Average (units) | 20,095 | | 37,471 | | 51,634 | | 69,159 | | 70,107 | | 80,684 | | 98,016 | |
| Total | 135 | 60 | 142 | 43 | 147 | 59 | 153 | 46 | 155 | 39 | 154 | 39 | 145 | 39 |

Source: The China Automotive Technology and Research Center (CATAR; cited in Marukawa 2013, 175).

Note: “Loss-makers” include firms with no profit.

In addition, Table 1-4 presents the concentration of auto firms. Previous studies have found that different concentration ratios in an industry are mainly caused by sectoral characteristics, such as production technology, scale economies, and the use of the product (Huang 2002, 544). Hence, same industrial sector tends to have similar concentration ratio, regardless of countries. In comparison to Brazil, Japan, and Korea during roughly comparable stages of automotive development, China is far behind, as the table shows. Furthermore, in the other countries, the trend was for the industry to become much more concentrated over time; however, in China, it became less concentrated after 1985 and only started to catch up at the end of the twentieth century.

Table 1-4. Automotive Industry Concentration Ratios: Four-Country Comparison (%)

| | One-firm ratio | Two-firm ratio | Three-firm ratio | Market size (Unit: million) |
|---------------|----------------|----------------|------------------|--------------------------------|
| Brazil | | | | |
| 1959 | 24.8 | 42.7 | 60.6 | 0.42 |
| 1970 | 56.1 | 74.3 | 91.2 | |
| Japan | | | | |
| 1960 | 32.1 | 56.1 | 65.1 | 0.41 |
| 1975 | 33.7 | 63.6 | 72.8 | 6.94 |
| Korea | | | | |
| 1975 | 54.6 | 77.7 | 96.4 | |
| 1986 | 71.3 | 88.6 | 97.9 | 0.97 (1987) |
| China | | | | |
| 1985 | 19.2 | 38.0 | 43.0 | |
| 1992 | 13.1 | 26.0 | 32.1 | 1.07 |
| 1994 | 13.5 | 26.6 | 35.7 | 1.16 |
| 1996 | 13.9 | 27.5 | 37.8 | 1.41 |
| 1998 | 14.7 | 25.4 | 34.4 | 1.60 |
| 2001 | 17.9 | 30.3 | 41.5 | 2.36 |
| 2003 | 19.3 | 37.3 | 47.9 | 4.39 |

Source: Data on Japan, Korea, Brazil, and China between 1985 to 1998 are from Huang (2002, 545). Data on China after 2001 are calculated from information available from the NDRC (2008, 868), Chinese Auto Industry Association and Chinese Auto Industry Advisory Committee (2014, 401).

Note: The market size column provides production figures.

The policy also failed to meet the second goal of promoting independent development. The AIP primarily supported large SOEs, but these beneficiaries relied heavily on their foreign partners' technology rather than becoming independent innovators. In 2004, FAW sold about a million cars including sedans and commercial vehicles. Only about half of these were sold with FAW brands. The other half carried foreign brands such as Volkswagen, Toyota, and Mazda. Passenger cars tend to be higher value-added products than commercial vehicles. Even in central SOEs, such as FAW, such high value-added products mostly relied on foreign technology. (See Table 1-5.) Among all new passenger car products in 2003, more than 70% employed imported foreign technology. The new cars that developed from independent technology are generally low

value-added vehicles (NDRC 2008, 701). Recently, the market shares of indigenous brand passenger cars have increased substantially, but the profit margins are meager compared to those of the foreign-brand cars.

Table 1-5. Breakdown of the FAW Sales Portfolio, 2004

| Categories | Sales Units (Unit: 10,000) |
|------------------------------------|---------------------------------------|
| medium and heavy truck | 18.8 |
| light truck | 7.6 |
| mini truck | 9 |
| bus | 1 |
| independent sedan | 15 |
| <i>Independent Total</i> | 51.3* |
| FAW-VW | 30 |
| FAW-Toyota | 9.3 |
| FAW-Mazda | 10.1 |
| <i>Foreign Brands Total</i> | 49.4 |
| total | 100.7 |

Source: FAW Group, April 2005 (cited in NDRC 2008, 955).

* This should be 51.4. Miscalculation is original.

During the late 1980s, a small number of SOEs were designated as passenger vehicle production plants: “three large” (*sanda*: First Auto, Dongfeng, and Shanghai Auto) and “three small” (*sanxiao*: Beijing Jeep, Tianjin Xiali, and Guangzhou Peugeot). These firms were the exclusive beneficiaries of preferential policies at both central and local levels of government. Section 3, Article 31 of the “1994 Auto Industrial Policy” stipulated that the joint ventures were to be established between the designated SOEs and foreign MNCs to export their automobile products and utilize export to solve the foreign exchange balance problem. Contrary to the AIP’s requirement, the designated firms have reaped the majority of their benefits from assembling foreign-brand cars. As shown in Table 1-6, the major automobile exporting firms are the recently

established indigenous companies that entered the industry in violation of the industrial policy. A Chinese analyst summarized two decades of failure of the auto industrial policy as follows: “The encouraged firms were wasted, the limited ones were animated, the specific policy goals were lost, and the policy overall was distorted” (Hu 2003, 34).

Table 1-6. China’s Top 20 Auto Exporting Firms: Performance, and Ownership Type in 2012

| Firm | Number of Exports (Unit: 1,000) | Percentage | Ownership Type |
|-----------------------------|--|--------------------------|--------------------------------------|
| Chery Auto | 168 | 16.98 | Municipal SOE |
| Shanghai Geely Jiafeng | 98 | 9.9 | Private |
| Changcheng | 74 | 7.48 | Private |
| Anhui Jianghuai | 51 | 5.15 | Provincial SOE |
| Chongqing Xiaokang | 46 | 4.65 | Private |
| Lifan | 46 | 4.65 | Private |
| Shanghai-GM-Dongyue* | 38 | 3.84 | JV |
| Honda China | 30 | 3.03 | Foreign |
| Beijing Foton | 29 | 2.93 | Subsidiary of BAIC |
| BYD | 23 | 2.32 | Private |
| Zhejiang Gonow | 23 | 2.32 | Domestic JV between GAIC and private |
| Hafei | 17 | 1.71 | Private |
| Jiangxi Jiangling | 17 | 1.71 | ? |
| Shanghai-GM | 14 | 1.41 | JV |
| Shanghai-GM-Wuling | 14 | 1.41 | JV |
| FAW | 12 | 1.21 | Central SOE |
| Chery Overseas Investment | 11 | 1.11 | Municipal SOE |
| ZXAUTO | 10 | 1.01 | ? |
| Nanjing Nanqi | 9 | 0.91 | Subsidiary of SAIC |
| King Long | 8 | 0.80 | ? |
| | Export Total: 989,000 | Total: 74.62% | |

Source: Export numbers and percentages are calculated from information available from the Statistics Division of General Administration of Customs (2013, 24–25). Company ownership types are according to each company’s official website.

Note: SOEs and their subsidiary JVs that are the primary beneficiaries of the AIP are in bold.

1.4 Introducing Market Mechanisms into Transitional China

The Central Committee of the Chinese Communist Party (CCP) expanded and deepened the designated role of the market in resource allocation from a “basic function” in 1993 to a “decisive function” in 2013.⁸ While market mechanisms have become increasingly important during the last 20 years of economic reform, the state has maintained and sometimes strengthened its control over SOEs. The 1993 CCP Central Committee decision regarding the socialist market economy emphasized building large enterprise groups equipped with international competency. In 1997, a report to the 15th CCP Congress also called for forming large enterprise groups with international competitiveness through market mechanisms. Furthermore, in 2001, the state council issued a document entitled “Guiding Advice for Developing Large Enterprise Groups with International Competitiveness.” In other words, expanding reliance on market mechanisms for resource allocation and strengthening the party-state’s power over large SOEs go side by side in contemporary China.

Previous studies have usually framed the relationship between the state and the market as oppositional; on this view, the economic transition is a linear transformation from state-directed planning to a market-driven economy. This “transition orthodoxy” (Nolan and Wang 1998) or “plan to market narrative” (Heilmann and Shih 2013, 21), which is strongly advocated by the World Bank (1996a, 1996b; Tenev, Zhang, and Brefort 2002; Yusuf, Nabeshima, and Perkins 2006), has led frequently to inaccurate diagnoses of the market transition. It has also obscured the real changes of political economy in transitional China. For instance, after witnessing the privatization or ownership transformation of small and feeble SOEs that took place under Premier Zhu Rongji (1998–2003), some scholars depicted China as on “the race to market”

⁸ “Decision of the Central Committee of the Communist Party of China on Some Problems Concerning the Socialist Market Economy System,” November 14, 1993; “Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform,” November 12, 2013.

(Story 2003). But in the following period of President Hu Jintao and Premier Wen Jiabao (2003–2013), “the state advance[d], the private sector retreat[ed]” (*guojin mintui*; Eaton 2015) and a description of China’s system as “state capitalism” gained popularity (Bremmer 2008; The Economist 2012). But as the saying from the *Boston Globe* goes, “In rejecting Lenin it is not necessary to embrace Milton Friedman” (cited in Nove 1992). The transition orthodoxy and plan to market narrative construct political economy too simply, as if the only two choices really are Lenin or Milton Friedman.

Discussions of the market transition usually assume that the planning and market systems are mutually exclusive. The widely-held conclusion, drawn from a simplistic view of the transitions in the Eastern European countries and the former Soviet Union, is that only privatization can solve the industrial problem in communist countries. The World Bank has generally espoused the transition orthodoxy (Nolan and Wang 1999) or “plan to market” narrative (Heilman and Shih 2013), and their logic and prescriptions were quickly expanded to China (Tenev, Zhang, and Brefour 2002; Yusuf, Nabeshima, and Perkins 2006). As shown in Table 1-7, however, the Chinese economic transition, especially after the state endorsed the SME, has not adhered to the transition orthodoxy. First, from the perspective of transition orthodoxy, reform must start with an anticommunist revolution, because a “reform reduces the power of the bureaucracy by definition, and most of the administration will inevitably oppose reform” (Aslund 1989, 14, cited in Nolan and Wang 1999, 171). Yet the political power of the Chinese Communist Party remains undiminished. Second, privatization is viewed as an “indispensable process” that will ensure a complete break with the old planning economy. The reality in China proves this assumption to be false. While selective privatization did occur, state asset management, especially for the large SOEs, grew stronger at the same time. The total number of

SOEs decreased, but SOEs' overall share in strategically important sectors increased. Third, contrary to the orthodox prescription that small enterprises must be promoted, China did the opposite, especially after 1992. Initially, small TVEs (Township and Village Enterprises) were the leading forces of economic reform; however, after the endorsement of the SME, "grasp the large, let go of the small" became the principal direction of the reforms. Finally, rather than "close" integration with the global economic system, China employed "strategic" integration. In short, the Chinese party-state has strategically mediated the rhythms and modes of the globalization of China's economy.

Table 1-7. Comparing “Transition Orthodoxy” and China’s Political Economy

| | Prescriptions of “Transition Orthodoxy” | Chinese Political Economy during the SME |
|---------------------------------------|--|---|
| Antibureaucratic revolution | “The collapse of communist one-party rule was the sine qua non for an effective transition to a market economy.” (Lipton and Sachs 1993, 34) | Continuing one-party rule |
| Privatization | Enterprise reform must be equated with privatization. Private property is the only means for owners and managers to “take responsibility for the full range of business decisions and for the financial benefits and costs of those decisions.” (IMF et al. 1990, 16–17) | Selective privatization and the strengthening of the state asset management system through establishing personified shareholders for state-owned assets |
| “Close the large, support the small.” | “For the most part, Eastern Europe’s production sector is composed of large, inefficient firms. Many, if not most, of them will have to close, and others will need to shed labour on a large scale.” (Blanchard et al. 1991, 64–65) | “Grasp the large, let go of the small.” |
| Globalization | “Close” integration into the international economic system accelerates growth in the reforming economies. | Strategic integration |

Source: Compiled by author from Nolan and Wang (1999).

1.5 State Capitalism and the Chinese Economic Miracle

About three decades ago, strong government coordination headed by the Ministry of International Trade and Industry (MITI) was regarded as the primary factor behind the Japanese economic miracle, as described in Johnson’s (1982) *MITI and the Japanese Miracle*. More

recently, Kellee Tsai and Barry Naughton (2015) recognized state capitalism as the major force of the Chinese economic miracle, as reflected in the title of their edited book's introduction: "State Capitalism and the Chinese Economic Miracle." Chinese state capitalism, however, has just started to take its own shape. Furthermore, as Tsai and Naughton put it, "China's state capitalist system was not in place at the beginning of China's growth miracle, it developed in tandem with the acceleration of growth, and it was shaped by the desire of China's leaders to facilitate rapid growth" (20).

Johnson's (1982) summary of the Japanese developmental state (DS) might provide a useful benchmark for understanding how the Chinese situation is different: "One clear lesson from the Japanese case is that the state needs the market and private enterprise needs the state; once both sides recognized this, cooperation was possible and high-speed growth occurred" (318). The initial condition for Japanese-style rapid growth was premised on the existence of a separate market and state. The DS model relies on a competent bureaucracy that can persuade independent private enterprises that they need help from the state, and eventually induce cooperation between them. But in command economies, firms are not separate entities, but parts of the state. In Eastern European countries and the former Soviet Union, enterprise reform was equated with privatization. Hence, the states swiftly retreated from the economy and discontinued their role as an economic control tower. In China, however, enterprise reform was never associated with privatization, so the reform process has been much slower (Nolan and Wang 1999). Moreover, the state has not thoroughly retreated from the economy, and therefore enterprise reform has required complex complementary adjustments in the state bureaucracy, state-business relations, and central-local state relations.

The massive changes in these realms could not possibly have been initiated from the beginning of the Chinese economic reform in 1978. During the early period, the state allowed “creative destruction” to disrupt protected bureaucratic relationships and downsize the bulky state sector (Naughton 2015). Naughton (2008) divided the Chinese economic reform into two distinct periods. In the first (1978–1993), the reform was somewhat passive, because power at the top was fragmented and many players, such as revolutionary elders, made reform difficult. Thus, it was impossible to follow a clear blueprint to restructure previous institutional templates. Enterprise reform in this period did not touch the fundamental ownership structure, but decentralized or transferred management rights to lower authorities. In this way, the first-period reform was “reform without losers” (Lau, Qian, and Roland 2000) and “growing out of plan” (Naughton 1995). At the start of the second period (from 1993 onwards), which was signaled by the state’s promulgation of the socialist market economy, a full range of comprehensive reforms was initiated. Many of the revolutionary elders who had impeded comprehensive economic reform had passed away by this time. The success of the early period of economic reform also enabled the reformist leadership to consolidate its power. The comprehensive reforms inevitably resulted in losers, so market-driven reform was pursued in tandem with centralization reforms. Industrial policy was actively promoted in this context as an important means of macroeconomic policy.

As mentioned earlier, sectoral industrial policy was first introduced to the automotive industry in 1994. In predicaments common to most late-developing countries, the Chinese auto industry faced a chronic shortage of capital investment and a trade deficit caused by the low quality of domestic cars. The Chinese government attempted to restructure the automotive industry through an industrial policy closely modeled on that of neighboring Japan and South

Korea. The AIP distorted market prices and artificially raised profit rates in order to draw higher investment. The profit rate for the auto assembly industry at international levels was about 10% on average, but it was raised to 30–60% in China (Yu 2006). At the same time, a strict entry barrier was built to enhance the economy of scale of a targeted group of firms. In the 1994 and 2004 AIPs, addressing the problem of too many assembly plants and dispersed investment (*san*) was regarded as the most important policy goal. While the Chinese central government attempted to apply DS-style industrial policy, China's unique characteristics as a continent-sized authoritarian transitional economy severely hampered government coordination. In a DS, the central government's firm grip over the financial sector allows the government to both guide capital investment and exercise political control over private enterprises (Woo 1991). Even though high physical capital investment (more than 40% of the GDP in recent years) has been a crucial factor behind China's economic miracle (Knight 2014), conditions in China have made government coordination much more difficult. The central government purview of capital investment in the auto industry had been continuously decreased. Contrary to the persistent decline of the capital investment by central jurisdiction and state-holding firms, investments by local jurisdiction and private has been increasing. The patronage of local governments enabled the expansion of investments by private firms. This unintended capital investment structure has implications for our understanding of the relationship between the state and private firms in the Chinese State capitalism.

1.6 Organization of the Dissertation

The dissertation is composed of seven chapters. Chapter 2 positions the puzzle of Chinese auto industry's rapid growth amid failed policies in the context of Chinese transitional economy. In

order to identify the position of industrial policy in transitional China, the chapter first looks at the temporal structure of policy change in the transition China. Then, I identify the expected role of industrial policy for building the Socialist Market Economy (SME). In addition, I present what doing fieldwork in a highly competitive industry looks like.

Chapter 3 analyze how the recurrent central government reshufflings impact on the auto industrial policy implementation with analysis on the historical evolution of industrial governance in the Chinese auto industry. The frequent government organizational reforms seriously reduced government autonomy and dismantled institutional continuity, which are the minimum necessary conditions for effective industrial policy implementations.

Chapter 4 examines how the efforts to reshape state-business relations led to the emergence of a dual structure in the auto industry. The Chinese central state's dualistic approach to SOE reform not only affected the overall rebalancing of the industrial distribution of SOEs, but also shaped the unique corporate governance structure.

Chapter 5 investigates the relationships between central-local fiscal restructuring and the rise of new local states' development model. The subprovincial governments' changes in development incentives subsequently influence on the formation of the competing coalition in the auto industry.

Chapter 6 attempts to uncover an understudied industrial governance mechanism of Chinese state capitalism by comparing the automobile, machinery, and petroleum industries to answer two questions: Why was industrial policy not promulgated in the other pillar industries when the automobile industry policy was introduced? Why do the market competition structures of the automobile industry and the other industries differ?

Chapter 7 concludes with the clarification on this study's theoretical and methodological implications. Then, I will illustrate some features of China's state capitalism.

CHAPTER 2

Framework

2.1 The Temporality of Policy Change in Transitional China

The main rhythm of policy changes in democratic states is determined by regularly held elections that change political leaders and policy priorities. In addition to regular elections, political parties and interest groups also transmit popular demands through legislative procedures. In autocratic China, however, administration, legislation, judicature, and the political party are de jure independent, but de facto interconnected. Thus, the personnel and power among them are undifferentiated. As the term “governing the state through the party” (*yidang zhiguo*) indicates, the Communist Party and state were not designed to check and balance each other; the former is the tool to govern by the latter. Despite the Communist Party’s huge emphasis on the masses (*qunzhong*), which facilitates input from society to state, the underdevelopment of institutions such as party systems or interest groups requires a much larger role of the state than in democratic societies. Policy makers in China must diagnose problems by themselves without knowing much about the problems. The heavy burden on the state induces two chronic and interrelated governance problems: a lack of policy continuity and a low level of institutionalization. As vividly illustrated in David Lampton’s (2014) recent book, Chinese government officers are confronted by too many agendas to coordinate (*xietiao*) them.⁹

The Chinese party-state has devised unique methods to remedy the policy discontinuity problem. According to Cheng Siwei (2004, 6), who is a famous economist and also a former vice

⁹ It may also be plausible to argue that the lack of policy continuity is caused by rapidly changing situations induced by China’s reform since 1978. But if we look into China’s government institutional reforms after the establishment of the People’s Republic of China, it is obvious that frequent government reshufflings are not a new problem rooted in the 1978 reform. For the early period of government organization, see Fang and Huan 1987.

president of the Standing Committee of the National People's Congress (NPC), the five-year state development plan system is inherited from a mid- and long-term planning tradition and has been designed to maintain policy continuity between leadership changes. Following the five-year plan system, the terms of (1) the members of the Political Bureau of the CCP Central Committee, (2) the members of the National People's Congress, and (3) the State Council leaders are all set at five years. New tenures of the leaderships in the NPC and the State Council start in the third year of the five-year plan that was created by the former government. For example, the 10th Five-Year Plan (10-5 plan) ran from 2001 until 2005. The 10th NPC president, Wu Bangguo, began his five-year tenure in 2003. The new heads of the State Council, President Hu Jintao and Premier Wen Jiabao, also began their first tenure in 2003 after getting the approval of the newly organized NPC. During the first two years of their first term (2003–2005), President Hu and Premier Wen would draft their policies along the direction of the 10th Five-Year Plan, which was outlined by the former leadership. Furthermore, to enhance the continuity between five-year plans, new methods have been devised recently, from the 11th Five-Year Program (11-5 program), such as interim evaluation of the previous program's implementation. More methods to induce input from academic circles and the public on policy-making processes were also introduced in the 11-5 program. The National People's Congress reviewed the outline of the 11-5 program and put forth the opinion to revise it. Such active participation by the NPC in five-year plan making is also a new development (Ma 2006).

Notwithstanding its expected role and alleged descent from a tradition of mid- and long-term plans, the plan itself did not have overall effects on Chinese policy change. Ironically, the importance of the five-year plan was being emphasized when China changed its direction towards a market economy (Heilamann 2011; Heilmann and Melton 2013). Although Cheng

Siwei (2004) stressed the tradition of long-term planning, the tradition was imagined after China's reform rather than actually having existed during Mao's period. Before the Chinese reform, the Chinese central state had not been able to draft and implement a long-term plan. During the planning period in China, only the first five-year plan (1953–1957), which was drafted with the support of Soviet experts, was publicly released. The second five-year plan (1958–1962) was passed in the Eighth Congress of the CCP in 1956, but the official document failed to be promulgated due to changes of a guiding principle. In 1966, drafting work on the third five-year plan (1966–1970) started, but the sudden uprising of the Cultural Revolution prevented the formation of the plan. The fourth five-year plan (1971–1975) was never fully developed into a final draft; only the “first draft” was issued. Drafting work on the fifth five-year plan (1976–1980) began in 1974, but was included in the “1976–1985 National Economic Development Decade Plan,” rather than being a separate text. A decade plan, however, was released in 1977, so this five-year plan shrunk to cover the remaining three years. In the end, the sixth five-year plan (1981–1985) was the first that could be called a plan (<http://dangshi.people.com.cn/GB/151935/204121/>).

The grand designs of reforms are set forth and released through results, decisions, or resolutions of the CCP National Congress or the Politburo of the CCP Central Committee. Once party decisions require changes in government responsibilities, the following government organizational reforms coincide with leadership changes in the State Council. Temporally, the five-year plan seems to guide the rhythms of the CCP Central Committee and State Council, but it has not functioned as a powerful driving force. Table 2-3 shows the temporal sequence of the five-year plans, Central Committees of the CCP, State Councils, and the Chinese National People's Congress leadership.

Table 2-1. Five-Year Plans, Central Committees of the CCP, and State Council/National People’s Congress (CNPC) Leadership, 1981–2010

| | Five-Year Plan | Central Committee of CCP | State Council / NPC |
|------|--------------------------|---|---|
| 1981 | 6-5 Plan (1981–1985) | 12 th CCP Sep. 1982–Oct. 1987 | Zhao Ziyang (6 th NPC) Jun. 1983–Apr. 1988 |
| 1982 | | | |
| 1983 | | | |
| 1984 | | | |
| 1985 | | | |
| 1986 | 7-5 Plan (1986–1990) | 13 th CCP Oct. 1987–Oct. 1992 | Zhao Ziyang to Li Peng* Li Peng (7 th NPC) (Apr. 1988–Mar. 1993) |
| 1987 | | | |
| 1988 | | | |
| 1989 | | | |
| 1990 | | | |
| 1991 | 8-5 Plan (1991–1995) | 14 th CCP Oct. 1992–Sep. 1997 | Li Peng (8 th NPC) (Mar. 1993–Mar. 1998) |
| 1992 | | | |
| 1993 | | | |
| 1994 | | | |
| 1995 | | | |
| 1996 | 9-5 Plan (1996–2000) | 15 th CCP Sep. 1997–Nov. 2002 | Zhu Rongji (9 th NPC) (Mar. 1998–Mar. 2003) |
| 1997 | | | |
| 1998 | | | |
| 1999 | | | |
| 2000 | | | |
| 2001 | 10-5 Plan (2001–2005) | 16 th CCP Nov. 2002–Oct. 2007 | Wen Jiaobao (10 th NPC) (Mar. 2003–Mar. 2008) |
| 2002 | | | |
| 2003 | | | |
| 2004 | | | |
| 2005 | | | |
| 2006 | 11-5 Plan (2006–2010) | 17 th CCP Oct. 2007–Nov. 2012 | Wen Jiaobao (11 th NPC) (Mar. 2008–Mar. 2013) |
| 2007 | | | |
| 2008 | | | |
| 2009 | | | |
| 2010 | | | |

* The 23rd plenary session of the Sixth National People’s Congress, November 23–30, 1987, decided that Li Peng replace Zhao Ziyang as premier of the State Council.

Note. Highlighted years in the first column indicate the year that central government organizational reform occurred.

In addition to the weakness of the tradition, the feeble institutional basis of the five-year plan made the problem worse. As highlighted in Table 2-1, in 1982, 1988, 1993, 1998, 2003,

2008, and 2013, there were large-scale government organizational reforms.¹⁰ In sharp contrast to the continuity of the Japanese Ministry of International Trade and Industry (MITI), Japan's economic pilot agency, in China the "historical, organizational, and also biographical continuities" of the government agencies in charge of the five-year plans are shaken by these numerous government organization reshufflings (Johnson 1982, 309). Despite the continuous evolution of the five-year plan and its increasing importance, the weakness of the tradition and the various government organizational changes have limited the five-year plans' ability to affect policy continuity.

Instead of being determined by the five-year plan, the overall rhythm of reform is orchestrated by CCP decisions. The 1993 proposal for the government organizational reform also institutionalized the procedure of reform work. First of all, the National Congress of the CCP, which is held every five years, proposes missions of reform. Then the CCP Central Committee reviews and discusses the proposal. Finally, the first meeting of the NPC examines and ratifies the proposal for State Council organizational reform (Wang 2008, 85). Policy changes usually occur when new government leadership is established with new government agencies. The government organizational reforms and leadership changes coincide, because the year of leadership change is the beginning stage and at the same time often marks the retirement of some officials who have resisted reform. In his recently published memoirs, former premier Zhu Rongji described the stubborn resistance he faced, recollecting that when he talked with dozens of ministers about organizational reforms, not a single minister expressed the need for their own ministry's abolition (Wang 2013).

¹⁰ Except in 1982, government organizational reforms have coincided with leadership changes in the State Council. The 1982 government restructuring took place a year earlier than the State Council leadership change.

Central government organizational reforms affect not only the central government, but also the lower-level local governments. One of the salient features of the Chinese government is the “isomorphic responsibility” system. This means that, vertically, different levels of government are responsible for the same functions and have equivalent bureaus (*duikou*) at each level. For example, if a National Development and Reform Commission is set up at the central level, provincial and municipal governments also need to set up their own Development and Reform Commissions to harmonize their structure with the central government’s (Zhu and Zhang 2005). Facing the 1998 government reform, then-Premier Zhu Rongji made a speech to local cadres about the magnitude of government organizational reforms:

The State Council system only has 30,000 people, so the difficulty of organizational reform is relatively small. But local government organizational reforms are not that easy. The number of cadres in the party and government is about 8 million, or 5.3 million if we calculate government officials only. Reducing by half means 2.6 million, so the difficulty of personnel layoff is very high. (Zhu 2011, 34; my translation)

If central government organizational reforms cause changes at the very lowest level of government agencies, such changes also hold for every realm of state policy. The lead government agencies in charge of industrial policy also have been reorganized according to recurring government organizational reforms. (See chapter 3 for more detail.) The reforms of the lead agencies for the automobile industry therefore have been affected by the government organizational reforms across the years of leadership changes. The five-year rhythm of policy

and organizational changes is frequent enough to disrupt historical, organizational, and biographical continuity in industrial policy, even though it has been becoming more institutionalized than the previous sporadic changes. If we focus on the institutional changes governing the auto industry, reforms before 2003 seem to have occurred more sporadically and without concurrent leadership change.

Table 2-2 presents a list of central state agencies' publications regarding industrial policies from 1987. Before industrial policy was officially adopted as a pillar of macroeconomic control, research institutes such as the Developmental Research Center of the State Council and Chinese Academy of Social Sciences published internal documents to promote industrial policy. While not yet adopted as the primary macroeconomic control tool, the first industrial policy in China, "State Council's Decision on the Main Points of Current Industrial Policy," was issued in March 1989. The SPC was assigned to be the primary industrial policy organization, and it also internally published a book as a manual and teaching material for officials. In the 1998 government organizational reforms, the SETC was officially assigned to be the main organization for industrial policy, but the SDPC, the successor of the SPC, still published a book on industrial technological policy.

Table 2-2. Publications on Industrial Policies by Central State Organizations

| Year | Central Organization | Publication Title |
|------|----------------------|--|
| 1989 | DRC | Studies on Chinese Sectoral Industrial Policy [<i>Zhongguo bumen chanye zhengce yanjiu</i>] |
| 1989 | SPC | Industrial Policy Handbook [<i>Chanye zhengce shouce</i>] |
| 1990 | CASS | Studies on Chinese Industrial Policy [<i>Zhongguo canye zhengce yanjiu</i>] |
| | SPC | Our State's Current Industrial Policy Problem [<i>Woguo dangqiande chanye zhengce wenti</i>] |
| 1999 | SDPC | Comparative Research on Foreign Countries' Industrial Technology Policy [<i>Guowai chanye jishu zhengce bijiao yanjiu</i>] |
| | SETC | China's Industry Association: Reform and Exploration [<i>Zhongguo hangye xiehui: Gaige yu tansuo</i>] |
| 2000 | SETC | Studies on China's Current Industrial Structure and Industrial Policy Options [<i>Zhongguo gongye jiegou xianzhuang fenxi yu duice yanjiu</i>] |
| | SETC | Industrial Policy Working Handbook, Vol. I [<i>Chanye zhengce gongzuo shouce diyiji</i>] |
| 2001 | SETC | Industrial Policy Working Handbook, Vol. II [<i>Chanye zhengce gongzuo shouce dierji</i>] |
| | SETC | "10-5" Industrial Plan and Development Strategy [<i>"Shiwu" gongye guihua yu fazhan zhanlue</i>] |
| 2004 | NDRC | Research on Integrated Policies for China's Sustainable Industrial Development Vol. I, II, and III [<i>Zhongguo kechixu fazhande chanye zhengce yanjiu Shang, Zhong, Xia</i>] |
| 2006 | NDRC | China's Industry Development and Industrial Policy [<i>Zhongguo chanye fazhan yu chanye zhengce</i>] |
| 2011 | MIIT | Report on China's Industrial Development and Policy (2011): Adjustment and Upgrade (with CASS Institute of Industrial Economy) [<i>Zhongguo chanye fazhan he chanye zhengce baogao 2011: Tiaozheng yu shengji</i>] |
| 2012 | MIIT | Report on China's Industrial Development and Policy (2012): Industrial Transfer (with CASS Institute of Industrial Economy) [<i>Zhongguo chanye fazhan he chanye zhengce baogao 2012: Chanye Zhuanyi</i>] |

2.2 Industrial Policy and the Building of the Socialist Market Economy

The meaning of industrial policy in a transitional economy is entirely different than it is in a market economy. Even the term for "industry"—a collective noun referring to businesses that provide the same products and services—is a neologism in reformed China, because a minimally functioning market exchange system is a necessary condition for industries in this sense. In the Soviet-style planned economy, the state was the sole owner of the means of production, and all

production units were disaggregated to different administrative ministries or bureaus. Production units were subordinated to the respective administrative units, and all production and exchange were circulated according to administrative chains. The following anecdote, from the recollection of the senior official who had participated in the drafting work for economic reforms, shows why the same type of product, when it is consumed and produced at factories with different affiliations, cannot be grouped in a single industry in such a system:

In the northeastern city of Shenyang, two factories adjoined each other. One was an electronic transformer plant affiliated with the Ministry of Machine Industry; the other was a copper metallurgy factory affiliated with the Ministry of Metallurgy. The copper required in the transformer factory was procured in quantity from far-away Yunnan through the channel of the Ministry of Machine Industry; by contrast, the copper produced in the neighboring metallurgy factory was distributed to the whole country through the channel of the Ministry of Metallurgy. Although the two plants were located next door to each other, the factories' different affiliations, which decided where they procured raw materials and distributed finished goods, made transactions between them impossible. (Gao 2008, 51–52; my translation)

The SETC document called the situation described in the anecdote “management by units” (*bumen*), and the goal of reform “management by industry” (*chanye*).¹¹ Transitioning from the former to the latter would clearly entail multiple interconnected changes. First of all, business enterprises that were part of the government during the planning period would have to be

¹¹ About book-length description of the same mechanism, see Naughton 1995.

released from direct government supervision to become principal agents of market competition; as a corollary, the government would need to change its mode of management from direct to indirect. Second, once businesses were separated from government, the government would have to take on previously nonexistent roles as market regulator and owner of state-owned assets. Finally, the Chinese state would need to develop new tools for macroeconomic control (Bureau of Economic Operations, SETC 2003, 174).

The first period of reform (1978–1993) was a period of “Hayekian experimentalism” carried out in an ad hoc manner under the nonstrategy of “groping for stones to cross the river” (Yang 2004). The ad hoc reform, however, reached an impasse and culminated in a confrontation between state and society in the 1989 Tiananmen Incident. This bloody confrontation highlighted the urgent need for a new direction of reform. After a few years of exploration and adjustment, the official endorsement of the socialist market economy (SME) in 1992–1993 put an end to the argument over the market ignited by the Tiananmen Incident. China finally embraced market mechanisms as the primary means of resource allocation for the first time in the history of the People’s Republic of China.¹²

The official endorsement of the SME opened the second phase of Chinese reform, which required “Polanyian programmatic reform,” departing from “Hayekian experimentalism” (Yang 2004). As Polanyi (2001 [1944], 145) put it, “free markets could never come into being merely by allowing things to take their course ... *laissez-faire* itself was enforced by the state.” Active state involvement is necessary to develop a governance structure, rules of exchange, and conceptions of control (Fligstein 2001). Because the controversy over markets had just ended,

¹² Jiang Zemin first introduced the concept of the socialist market economy in his speech at the Party School of the Central Committee in June 1992. The term was officially endorsed at the 14th CCP Congress in October 1992. The content of the SME was shaped by a decision ratified at the third plenary session of the 14th CCP Central Committee in November 1993.

however, active state involvement in the accompanying reforms had to reflect concerns raised by anti-market groups. Having witnessed the collapse of the U.S.S.R. and the Eastern European Communist countries in the 1990s, many intellectuals, especially from the “New Left” group, were worried about weakening the central’s state capability (*China Youth Daily* 1991; Wang and Hu 1993). Hence, building a socialist market economy needed to accomplish seemingly contradictory goals: while businesses became the principal agents of market competition, the central government wanted to strengthen its fiscal capacity and control over strategically important enterprises and industries.

Transitioning from “management by units” to “management by industry” did not mean the market completely replaced the planning system. Chinese policy makers did not see market reform as a linear transition from a planned to a market economy (Heilmann and Shih 2013; Nolan and Wang 1999). In the process of China’s transition, the market was never allowed to replace the old system, but only gradually allowed more room to work as long as it remained under the control of the Chinese Communist Party and increased the country’s productive force. According to the Constitution of the Chinese Communist Party, the goal of China’s basic economic system is to keep “*public ownership* playing a dominant role and allow *different forms of ownership* to develop side by side” (my emphasis).¹³ The SME is a dual-track system of a dominant public economy in strategically important industries and a market economy in other areas. In 2000, then-President Jiang Zemin elaborated the basis of the Chinese socialist market economy:

¹³ For the full text of the Constitution of the Chinese Communist Party in Chinese and English, see http://news.xinhuanet.com/english/bilingual/2012-11/18/c_131982634.htm.

In our country, the CCP is the governing party, guiding the people and exercising the power of the state. Our socialist state regime needs efficient operation and should control a certain amount of economic and material capacities. ... Without a public economy that consists of the state-owned economy as the core, there will be no socialist economic basis; neither the reign of the CCP nor an overall socialist superstructure's economic base and strong material means. Leading cadres at various levels, especially high-ranking cadres, must be clearly and soberly aware of this point. (quoted in Li 2013, 3; my translation)

To uphold the CCP's political monopoly, there needed to be enough material support from the public economy. On the other hand, a "nonpublic ownership economy," which is equivalent to a market economy and mainly driven by private actors, was also indispensable. With a firm base of state-owned enterprises (SOEs) in strategically important sectors, the private economy was to be encouraged to prosper in other sectors because it is more conducive to market competition, industrial structural innovation and upgrading, fast development of the national economy, the introduction of advanced technology and management skills, and cooperation with global markets (Li 2013, 3–4).

After the CCP endorsed the SME, it began macro institutional reforms across government organizations, the tax system, and SOEs. In addition, the government began to introduce industrial policy as a new pillar of macroeconomic control to pursue control and efficiency simultaneously. A 1987 internal research article that circulated widely among top leaders suggested that industrial policy would be a useful tool for the Chinese-style economic system, which combined "competition" and "intervention" (Li, Zhou, Liu, and Lin 1999 [1987]). While

in market economies, industrial policy is pursued to remedy market failures and address externalities problems, in China's SME, industrial policy was primarily intended to maintain the public economy's dominant role. Thus, promulgating sector-specific industrial policies conveyed the central state's recognition of certain sectors' strategic importance and the state's will to develop the designated industries. The government's policy actions at this time substantially relieved worries about the central state's predatory behavior and incentivized multiple actors, including multinational corporations (MNCs), local governments, and even initially excluded private actors, to invest in the designated industries. In this way, industrial policy in authoritarian China functions as a "commitment technology" in the absence of stable legal property rights institutions (Haggard 2004).

2.3 Configurational Causal Chain of the Argument

This dissertation's analysis starts with an intensive case study, which demonstrates how industrial policy and macro institutional reforms to build the SME work together and how their combination can explain the rapid growth of the Chinese auto industry. As the case study of the auto industry in Chapters 3 to 5 demonstrates, government intervention through industrial policy has been fraught with huge policy failures.¹⁴ The auto industrial policy has been devised and implemented in the context of building the SME, and the complex interactions between industrial policy and macro institutional reforms have led to varying coalition structures in all of the industries to which government industrial policy has been attempted to be applied. Because these coalition structures directly shape the modes of competition in the given industries, Chapters 3 to 5 will explicate the configurational mechanisms of the auto industry in detail. Chapter 6 then

¹⁴ The major criterion of policy evaluation here is whether the original policy intentions have been realized or not. In some cases, the policy goals were achieved, but had no positive impact on industrial development. In these cases, for the purposes of this study, the policy is considered to have succeeded.

presents a comparative study across three “pillar” industries, i.e., machinery, petroleum and automobile, to explain varying level of industrial policy enactments and structures of market competition. All of the pillar industries were supposed to have an equal level of strategic value and be regulated by the same growth-promoting industrial policies, but the actual levels of policy implementation and resulting outcomes vary significantly across industries. Chapter 6’s comparative study uncovers understudied industrial governance mechanisms of Chinese state capitalism.

No single actor decisively influences the policy process in the modern political system, owing to the increasing complexity of problems and the growing need for organizational resources. Hence, scholars studying policy process, especially in Western democratic countries, have developed theories focusing on coalitions such as the Advocacy Coalition Framework (ACF), involving political parties, interest groups, administrative agencies, or subnational actors (Sabatier 1987). Interest in the role of coalitions in policy processes has been aroused by the premise that “coalition structure has consequences on the outcome of a policy process” (Fischer 2015, 245–246). While such theoretical frameworks developed in the setting of democratic countries, the same premise is applicable to Chinese institutional contexts. In China, where decision making and implementation are separate, policy outcomes tend to be more contingent on the coalition structure in policy subsystems. By taking account of all the main actors in the policy process, coalitional politics is better suited to explaining the linkage between industrial policy and economic performance.

Industrial policies define who can legitimately participate in the given industry by issuing licenses and screening investments. By thus drawing the boundaries of public ownership, industrial policies are intended to exclude all but a few actors in any given industry. In addition,

industrial policies target a few important industries, thus also excluding all other industries. Official industrial policies involve a great deal of policy support, so the majority of industrial actors aspire to having industrial policies in their domains.

On the other hand, macro institutional reforms to build the SME have readjusted the consolidated relations between policy actors. First, the government organizational reforms at short intervals aimed at breaking the close ties between central economic policy-making agencies and central state-owned enterprises (SOEs), but it ended up dismantling historical, organizational, and biological continuities of industrial policy agencies. Second, massive SOE reform, called “grasp the large, let go of the small,” provoked the formation of new coalition structures in the auto industry. The large SOEs were part of the state and resisted being left alone, and the central party-state also did not want to lose control over important industries. Their shared desire drove a reorganization of the large SOEs into pyramidal business groups under the hierarchy of the State-owned Assets Supervision and Administration Commission (SASAC). The decrease in the central government’s supervision capability caused by the government organizational reforms and the small and medium-sized companies that spun off from former SOEs opened the door for new actors to enter into the passenger car assembly industry. Finally, the 1994 tax-sharing reform enhanced the central government’s fiscal capacity, but it also changed local government tax incentives. The revised fiscal incentives consequently transformed the local development model, and local governments became eager to act as the patrons of these new actors. After the myriad reforms, two competing alliances in the auto industry, centered on the traditional SOEs and the new indigenous brands, have been created and finally hampered fulfilling the policy intentions.

2.4 Methods and Data

This study utilizes comparative-historical analysis (CHA) as the primary research method. Three core defining features of CHA are macroconfigurational research, case-based research, and temporally oriented research (Mahoney and Thelen 2015). First, the macro component entails “concern with large-scale outcomes” (5), as in this study’s discussion of the macro industrial changes in contemporary China. The configurational component refers to the specific mode of explanation of the macro outcomes. Instead of specifying the effect of X on Y, it examines “how variables work together in combinations or ‘causal package’ (Ragin 1987)” (7). I analyze the effect of auto industrial policy (AIP) by taking into account the institutional context in which the policies were adopted as a means of macroeconomic control. This study specifies three main institutional factors that have interacted with the AIP in the context of the building of the socialist market economy and the nature of its effects on auto industrialization. Second, case-based research “focus[es] on real-world puzzles” and the “use of mechanisms-based explanation” (12). Such problem-driven research seeks a deep understanding of actual, not stylized, cases. Furthermore, it takes a dynamic process-oriented approach to specifying the mechanisms at work, rather than a static institutional approach. Third, temporally oriented research is sensitive to temporal location and temporal structure. Instead of seeking a universal theory independent from temporality, I investigate the sequences of unfolding events and gradual changes of institutions over time.

Previous research on Chinese economic governance has studied single government bureaucratic agencies, such as what was once called the “little State Council,” the State Economic and Trade Commission (SETC, 1993–2003) and the National Development and Reform Commission (NDRC, 2003 onwards), as a primary level of analysis (Gore 2012; Jung

2008). Even though these studies have deepened our understanding of China's top economic management bureaucracies, bureaucratic agencies in China have been short-lived. Government agencies can come and go, but the problems of industrial transformation persist. Once central economic management agencies have either achieved or demonstrated they are not likely to achieve their designated goals, they are demolished or merged with other bureaucratic agencies. Therefore, tracking myriad administrative, state-business, and central-local reforms relating to certain industries is more suitable than targeting one central economic bureaucracy as a way to analyze rapid industrialization amid failed central policy implementations.

While industrial policy deals with varied industry sectors, regional developments, and even multiple industries, this dissertation research focuses on the auto industry for its intensive case study. What makes the auto sector a suitable case for the research? When the Chinese central state started to reform its Soviet-style planning system with economic measures in the early 1980s, the Chinese central planner designated a few industries as pilot experiment industries for the economic system and industry management reform. The auto industry was one of these pilot industries (Chen 2005, 274; *People's Daily* 1987, September 23). Later, when the Chinese central government selected a few sectors to become "pillar industries" in the early 1990s, the auto industry was also chosen to be one of them. The auto industry's extensive linkages with other industrial sectors and its symbolic meaning of representing a modern industrialized country add to its interest. The auto industry was the first sector for which the Chinese state issued industrial policy and the sector in which it has intervened most seriously (Eun and Lee 2002; Huang 2002). The long history and intensity of government intervention in the automotive industry make it one of the best industries to study to track the interaction between state intervention in the economic realm and macro institutional reforms.

The data for this dissertation were mainly collected during 18 months of fieldwork in China in 2012 and 2013. The study employs data collected from a variety of sources: interviews with the major players in the industry, archival research including internally circulated journals and books, publications from the central economic management agencies, memoirs of former high-ranking government officers, policy reports, academic writings, and statistical data. Most of these materials were not accessible until very recently. With the deepening of Chinese reform, these once sensitive materials have become a window to see into the black box of Chinese central government policy making.

2.5 Doing Fieldwork in a Highly Competitive Industry

I arrived in Beijing to begin fieldwork in midsummer 2012. I had been to this mega city many times since 2002, but the level of change brought by the past ten years' high growth was just astonishing. Facing what was clearly a transformed society, I had to surrender most of my expectations for my fieldwork research. One day not long after I arrived, I was walking in the Wudaokou neighborhood with a close friend who had studied Chinese with me back in 2002. As we walked, we recalled the area as it had been ten years before; almost every place we passed was entirely different. The muddy dirt road had been nicely paved, different brands of cars congested the road, and the lot where temporary tents for "peasant-workers" (*nongmingong*) had stood had become a trendy place for foreign students and tourists. As I witnessed these street-level transformations, I realized the auto industry I had been studying might not be an exception to the sea change that had swept the country.

When I started my fieldwork in 2012, China had already become the world largest auto producer and consumer. Many of my interviewees who worked in the sector believed that China might be one of the most competitive auto markets in the world. As one of the few countries that

has a very low level of motor vehicle ownership but a very high growth rate,¹⁵ the China market is irresistible to every global auto player. The result is vicious competition, which bodes ill for the researcher trying to get access to the inside of the Chinese auto industry. I was expecting to encounter challenges, and, having studied *Doing Fieldwork in China* (Heimer and Thøgersen 2006), I knew about “fieldwork as coping and learning” (Sæther 2006)—but the harsh competition looked like it would block many chances for learning from the beginning. The experts I wanted to interview were extremely busy, and I faced many hurdles as I tried to contact them. Even after I secured access, most of the interviewees were very cautious about sharing information with an unfamiliar outsider. Even though I put enormous effort into building rapport, many of them simply could not afford to let me occupy their time.

2.5.1 Why political economy?

For doing business in China, what kind of academic discipline is the most important? Political economy is the most important! What is political economy? Political economy is a combination of politics and business, politics plus economy: grasping politics in one hand, economics in the other hand, this is called knowledge! Learning political science only? No, it's obsolete. Learning economics only? No, that does not work either, we have not reached that kind of period yet. (a private entrepreneur in China, interview in Zhang and Lin 2010, 43, November 21, 2007; my translation)

My primary target interviewees were in both business and government. As the quote above suggests, government no longer prevails over business in China. At the same time, business must

¹⁵ In 2015, there were 125 cars per thousand people in China; by comparison, there were 809 cars per thousand people in the United States in 2011.

heed both market signals and government policies to be successful. Hence, my interviews usually started under a strange tension as my interviewees engaged in extended reconnaissance of me and my motives. To illustrate, in this section I provide examples of two kinds of interview circumstances I encountered. I first describe incidents from two interviews with a manager from an auto MNC, and I then describe an interview with a local official.

Interviewee 1: A manager from a foreign JV partner

January 15, 2013, and March 1, 2013

Company's China Branch Headquarters¹⁶

My interviews with this manager at a foreign JV partner took place in a conference room at his company's China branch headquarters. The company was well known for its "goose-flight type" advance into China. Following the auto assembler, parts suppliers, banks, investment companies, and even chambers of commerce advanced together to China. In the building's directory, I saw many company names from the same origin country, including an airline, a primary partner bank, investment companies, and a chamber of commerce. The building was centrally located in a commercial area known for extremely expensive real estate. The China headquarters of other companies from the same country were concentrated in the same area, many within walking distance. The organizational structures of the countries of origin seem to have been transplanted into Chinese soil (Florida and Kenney 1991). I later interviewed several other experts from the same origin country, meeting them at their offices or in restaurants located within a two-mile radius of this auto company's China headquarters.

¹⁶ I omit city names and other identifying information to maintain my interviewees' anonymity.

As the manager of the management planning department, my interviewee was in charge of negotiating with local governments. He had been involved in many negotiations with local governments in the company's efforts to expand its production capacity. The China market had been vital for the interviewee's corporation. Performance pressure is keen, so such managers are attentive to even small changes that can affect market conditions. For my interviewee, institutional changes in the Chinese central government or in the incentives offered by local governments were not abstract. Subtle changes in government policy could directly impact his position at the negotiation table. Hence, I was able to hear his interpretation of the nuanced meanings of policy and institutional changes, even before I could grasp the concrete implications.

Q: There is a news report that the Ministry of Industry and Information Technology (MIIT) recently replaced the National Development and Reform Commission (NDRC) as the leading government organ for the auto industry. What do you think about this?

A: The NDRC is the extended form of the planning department in the past years, so they are eager to manage and control the economy through policies. In contrast, the MIIT seems to believe in the effectiveness of market mechanisms more than the NDRC. The NDRC and the MIIT have had many conflicts on issues of approval and licensing before. Transferring control of the auto industry to the MIIT might reflect the Chinese government's willingness to trust market mechanisms more than regulations through industrial policy. Following this transfer, as far as I know the Chinese government will not promote new auto industrial policy anymore.

Q: How do local governments foster the automotive industry?

A: In general, local governments are using the following three ways to promote the auto industry. First, in the past, local governments granted the land free of charge, but now land use rights must be purchased. At present, local government grants subsidize the cost of purchasing land usage rights, or investments in infrastructure around the plants in the construction process. Second, the local government fully reimburses local corporate tax for three years. Third, local government provides apartments or residential areas for employees at low prices.

These interviews with a manager working at the business front allowed me a taste of doing business in China. He explained a lot of nuances that I could not know about as an outsider and pointed out whom I should interview. For example, he said that local government officers, not managers from companies, are his major negotiating partners. Following his information, as a next step, I identified what kind of local government officers negotiate with foreign investors, and why and how. But due to the highly competitive market situation, my interviewee was reluctant to share detailed information. When I asked him to share some written documents, he erased “sensitive” information using his own notebook computer in front of me and gave me an edited MS Word file filled with many blanks.

Interviewee 2: A local government official

Location: Foreign Investment Office of the Tianjin Municipal People’s Government, TEDA Building

November 5, 2013

This interview was held at the conference room, located in the building belonging to the Tianjin Economic-Technological Development Area (TEDA, *Tianjin jingji jishu kafaqu*). The development area (*kaifaqu*) was created in the early 1980s as a special administrative zone, and it has enjoyed subprovincial-level district administrative rank (*fushengjiqu*). Compared to other district-level (*qu*) governments within the Tianjin municipality, the development area government is not strictly bounded by the municipal government. While the area is geographically part of the Tianjin Municipality, it has semi-independent administrative units, which were designated a national-level development district (*guojiaji*) by the central government. Starting with Pudong Xinqu in Shanghai in 1992, the central government began to rename these development areas as “new districts” (*xinqu*) and it had designated 17 such national districts as of 2016. Although this development area was renamed Binhai New District in 2006, the building still uses the old name.

The TEDA (currently Binhai New District), is an administrative unit relatively independent from the Tianjin Municipal Government. The TEDA building, as the property of a profit-making legal entity, belongs to the Binhai New District government. Despite its independent status, active support from the municipal government is vital for “inviting business and attracting investments” (*zhaoshang yinzi*). While the Binhai government enjoyed autonomous status compared to other districts, its economic performance is also indispensable to the Tianjin Municipal Government in measuring Tianjin’s economic performance. These complementary interests led to the establishment of the Foreign Investment Office of the Tianjin Municipal People’s Government at the TEDA building. TEDA gave the 11th and 12th floors to

the Tianjin Municipal Government without compensation to house the Foreign Investment Office. Due to the notorious *tiao-kuai* (vertical-horizontal) relations¹⁷, the administrative procedures were extremely complicated. Hence, when TEDA was established in 1984, then-mayor Li Ruihuai suggested creating a “one-stop administrative office” to deal with foreign investment. Currently, the Commission of Commerce takes the leading organizational role, and the Commission of Economy and Information Technology as well as the Commission of Development and Reform also dispatched teams to the office. The office deals with all tasks related to investment promotion, especially resolving visa problems, registration (*hukou*) for employees, loans, and securing administrative approval and production licenses. Therefore, when “foreign”¹⁸ investors come to Tianjin, their initial business partners are government officers from this office.

The interview was conducted in one of the conference rooms at the Foreign Investment Office. I made the acquaintance of the government officer through my Chinese school network,¹⁹ and he not only introduced me to the interviewee but accompanied me throughout the interview. The interviewee worked in the village-level government in Tianjin Municipality, but he had previously worked in the Department of Equipment Manufacturing Industry at the Commission of Economy and Information Technology. The conference room was the place where foreign investors initially met with local government officials. On the inner door, there was a sign written in red Chinese characters: “Do not leak the contents of the meeting. Confidentiality is everyone’s responsibility.” My interviewee seemed very familiar with the meetings that took place in this room. Although our mutual acquaintance introduced me as a foreign scholar doing

¹⁷ For a discussion of *tiao/kuai* relations, see Lieberthal 2004, 186–188 and Mertha 2005.

¹⁸ “Foreign” means not only investors from other countries, but also investors from outside Tianjin Municipality.

¹⁹ Section 2.5.2 describes the process I used for contacting interviewees in detail.

doctoral research, when we touched upon technical problems, he replied to my questions by asking my intentions: “What do you do? Are you doing business, intelligence, or what?”

As these brief vignettes from my interviews suggest, the highly politicized character of market competition in the Chinese auto industry made it tough to gain access to relevant interviewees. As a coping strategy, I learned to exploit multiple aspects of my own identity in the process of the snowball sampling method I used to contact potential interviewees (section 2.5.2). In addition, although interviews with experts helped me to get a sense of the Chinese auto industry, they were not enough for gaining correct information. Therefore, I needed to devise multiple methods both to collect data and to cross-check the data (section 2.5.3).

2.5.2 Snowball sampling

At the beginning of my fieldwork research in China, I had many difficulties getting access to my target experts. On January 8, 2013, a personal acquaintance invited me to dinner with a junior editor at one of the CCP-run journals. The editor agreed to review my interview questionnaire. As a local Chinese working for a party organ, she had several useful suggestions for me:

Your survey questionnaire and invitation letter include lots of “sensitive” words that will make it difficult for people to agree to do an interview. You have to revise your research goal in much plainer language and without “sensitive” language. For many Chinese locals, interview requests from foreigners can be a dangerous endeavor. If you want access to local Chinese, you should try to get domestic credentials, such as a “letter of introduction” with the stamp of Peking University. If they see the Peking University stamp, they will be assured that you are a safe and important person.

As a foreign scholar, however, no matter how much I revised my questionnaire, my inquiry into one of the most competitive pillar industries touched on sensitive issues. For example, the fact that Chery Auto is the outcome of an Anhui Provincial government-backed secret project, although it is an open secret, is still hard for people to talk about. The editor also told me a locally circulated rumor about Chery, which is located in her hometown of Wuhu in Anhui Province:

For many Wuhu residents, Chery is considered the best place to work except the city government. Wuhu locals all know that Chery's technical level is much lower than that of foreign brand cars, and nobody from my family would purchase Chery cars, but they believe Chery is necessary for the prosperity of Wuhu's economy. Most of the taxis running across Wuhu are Chery-brand cars, and I think most of the locals might know the Wuhu government is working hard to support Chery in the shadows. I heard a rumor that the net profit for selling one Chery sedan is only 50 RMB (approximately 7.5 USD) and the price adjustment [that Chery got from] Ma'anshan Steel would have been impossible without the Wuhu government's pressure.

In our casual dinner table conversation, she was comfortable candidly discussing rumors about her hometown company. But when I contacted target interviewees because they held a certain position, I could not meet them for a casual dinner, especially for the initial meetings. However, if I could not assure my interviewees of my understanding of what was "sensitive," they would

not feel safe enough to talk with me. My identity as an interviewer therefore had to be customized to my interviewees. In the process of snowballing, I had to draw on various of my identities: as an alumnus from many different Chinese and non-Chinese schools I have attended, as a “friend of a friend,” as an audience member at conferences, and even as a customer interested in purchasing related materials.²⁰ Although China has become open to the outside world in many ways, Chinese network formation is still very exclusive. While I tried to expand my list of potential interviewees through my alumni network from my non-Chinese schools, it was very difficult to cross the border between Chinese and non-Chinese. To my request to introduce me to other Chinese experts, one non-Chinese government foreign service official refused, with the following rationale: “I know them very well. But if I introduce you to that agency, we have to ask a favor on behalf of you. We are working for our national interests, and we cannot sacrifice a national resource for the pursuit of your self-interest” (interview with an economic counselor at a foreign embassy, December 14, 2012, Beijing). While my foreign identity helped me to connect with non-Chinese experts working in China, I keenly realized that I could not reach the Chinese inner circle without an insider’s credentials.

As an effort to get such insider’s credentials, I joined a Chinese government-sponsored joint Ph.D. program hosted by Nankai University, a prestigious Chinese university located in Tianjin. Becoming a member of the research group (*tuandui*) led by my Chinese supervisor made a huge difference in how others perceived my identity. Incumbent Chinese government officers pursuing Masters of Public Administration (MPA) degrees under the supervision of the same adviser became my *shixiong* (senior brother) or *shimei* (senior sister). For example, one *shixiong* who was a professor at Nankai University introduced me to another *shixiong* who worked in a

²⁰ These are all true aspects of my personal identity. During the interview process with human subjects, I strictly abided by all the research guidelines suggested by the Human Studies Program of the Institutional Review Board (IRB) at the University of Hawai‘i at Mānoa.

department of a local government. As a member of the *tuandui*, I was invited to join the *tuandui*'s online mailing list and social media services as well as offline gatherings. The resulting horizontal information sharing and vertical guidance dramatically enhanced my access to the inside of Chinese policy processes. Furthermore, the *tuandui* credential transformed my "sensitive" foreign identity to that of a knowledgeable "China hand."

The process of interviewing experts created critical moments that transformed incomprehensible fast-changing facts into a connected story. They taught me how to mimic their perspectives. As James Scott (1999) tried "seeing like a state" to understand how certain schemes to improve the human condition had failed, I tried "seeing like an expert" and "seeing like an official" to understand the paradoxical success of the auto industry amid policy failures. The multiple lenses through which I learned to see by conducting interviews with experts in turn guided me towards the kind of supplementary archival documents I needed to augment my data. While the interviews taught me how to see the problems I was studying, they were not detailed enough to build a complete picture. Furthermore, no interviewee was free from ontological limits, so each piece of information had to be cross-checked and constructed again.

2.5.3 Cross-checking

Even though I learned how to see problems like my interviewees, I also needed to find out how deeply I could reach into Chinese archival systems. I made numerous trials and errors to probe the reachable layers. I visited central, provincial, and county-level archives and record centers (*dang'anguan*) to check what kind of archives were publicly accessible. Except for in a very few areas, such as the environment, agriculture, and military family support, most archives created since the establishment of the People's Republic of China have not yet become publicly

accessible.²¹ Administrative documents are not publicly released either, but fortunately many “internally circulated documents” (*neibu wenjian*) are accessible at university libraries, the National Library of China, and even a recently developed full-text searchable Chinese online database. This digital academic database was constructed by “officially sponsored mass scanning of previously unpublished material” and it allows access to a broad range of previously inaccessible internal documents and research reports (Heilmann and Shih 2013, 5). In addition, the fast commodification of old materials has made it possible to purchase previously unavailable documents through online used book markets.

An online database, the commodification of used books, and the implicit “declassifying” of many internal documents²² has made huge amounts of material accessible to researchers. In addition, these recent developments have also facilitated collecting data from numerous materials published in series. Due to *tiao-kuai* fragmentation, each *tiao* unit (e.g., auto industry, steel industry, coal industry, etc.) and *kuai* unit (e.g., provincial, country, and village governments) publishes their own yearbooks or local gazetteers. But even the most prestigious Chinese university libraries, such as those at Peking and Tsinghua Universities, do not house complete collections of these materials. Online databases and online used book stores have made it much easier to search and access the materials.²³

²¹ For a research guide for using Chinese official archives, see Diamant 2010.

²² Many “internal documents” are not systematically classified. These documents are printed in very small numbers and circulated exclusively to members of certain units (*danwei*). Once these units are replaced by other units, there is no authority to control the circulation of once “sensitive” documents, which are then frequently commoditized as scarce goods. I call this *implicit declassifying* because it does not involve any formal (de)classification process.

²³ These new changes have brought significant impacts on China studies. Only a decade ago, very few institutions, such as the Universities Service Centre (USC) for Chinese Studies at the Chinese University of Hong Kong, collected Chinese materials systematically. Due to the fragmented nature of Chinese policy making, it was difficult to find data covering policy implementations that ranged from central to local. For the contribution of the USC to China studies, see Vogel 2016.

CHAPTER 3

Recurrent Government Reshuffling and Its Impacts on Industrial Policy

3.1 Introduction

This chapter aims to explicate how the organizational changes of the Chinese central government affect the implementation of industrial policy. As shown in chapter 2, new policy changes in China coincide with government organizational reforms. The central government reshufflings significantly affect the central government's industrial governance capability by reducing autonomy and breaking organizational continuity. The central government reshufflings not only alter the industrial governance structure at the central level, but also impact the structures of local governments. The organizational changes of the central government consequently shape modes of industrial policy implementation.

The debates over East Asian developmental states (DS) have addressed the factors that contributed to rapid economic development in East Asian countries. Because the DS concept has enhanced our understanding of East Asian economic growth, many scholars have asked whether China was following the East Asian developmental state model (Beak 2005; Eun and Lee 2002; Lee, Hahn, and Lin 2002; Tsai and Cook 2005). Previous literature has pinpointed that China has deviated, significantly, from the core components of the DS for three different primary reasons. The first two reasons are related to *autonomy* and *embeddedness*, which were pointed out by Evans (1992, 1995) as positive features of the DS, and the last reason is about *timing*.²⁴ First, the

²⁴ The different timing of China's rapid growth is important, but outside the scope of this chapter. Even though fierce debates are still ongoing about the nature of globalization and the path of economic development for late-developers in the neoliberal globalization era, it looks like the external environment China now faces as a late industrializer is significantly different than it was during the Cold War period. China does not enjoy unilateral market access to the United States, as Japan and South Korea did. In addition, economic globalization and the strengthening WTO regime have shrunk the "development space" and delegitimized many industrial policy tools (Tsai and Cook 2005; Wade 2003). The "late development" model requires strong state institutional involvement in

Chinese state is not an “autonomous” state. Instead of the bureaucrats-qua-agents in the East Asian DS who had to follow the grand developmental goals set forth by their principals, Chinese bureaucrats were directly exposed to political logic, so they acted in a way that ensured the specific policies that would maintain their own power base and increase their chances of political survival (Shih 2004). Second, although the central party-state still retains some discretionary control through its monopoly over personnel appointments (Chan 2009; Heilmann 2005; Brødsgaard 2012), it seriously lacks connections to industrialists, land owners, and labor. In addition to these weak connections with business and society, decentralization has seriously weakened its connections with local governments.

From the beginning of China’s reform, Chinese central planners have initiated various rounds of government organizational reforms to build proper market institutions. The principal goals of these institutional changes can be thwarted in three different ways. First, official institutional change can be stymied by informal adjustment. The central state’s strategy of disembeddedness generated sociopolitical contention by dismantling preexisting social relations. This contention resulted in myriad informal reactions and finally led the proper functioning of market institutions astray (Lin 2006). Second, the central state’s reform efforts can also meet doom by being captured by the short-term winners of partial reforms (Hellman 1998; Liou 2014). In other words, particular groups can take control of the formal institution-building process to protect their vested interests. Finally, a central state scheme to build the market economy can also destroy the institutions that have practical knowledge about certain industries, leading eventually to failed policies. As James Scott (1988) illustrated, the modern state project takes the form of “simplification” to enhance “legibility,” but this “simplification” is frequently achieved

economic development (Amsden 1989; Gershchenkron 1962; Johnson 1982; Kohli 2004), but neoliberal globalization has rendered this old path impassible.

by destroying practical knowledge (“metis” in Scott’s term). The foremost goal of building the socialist market economy was *zhengqi fenkai* (separate government and business), but this separation also destroyed the government agencies that closely controlled and monitored businesses, which led to the central state’s lack of information on industries.

In empirical reality, an informal intrusion of formal institutions, captured institution building by early winners, and the state’s simplification scheme happened together. However, it is salient in Chinese reform that almost every five years there have been government organization reshuffles to sever close ties between central economic agencies and state enterprises. Consequently, official institutional changes have had more impact on the functioning of the market system than informal adjustment has had. Furthermore, various government reforms also have realigned the winners’ coalitions and made the early beneficiary groups difficult to discern.²⁵ In sum, the Chinese central state has reshuffled government organizations at short intervals to separate state and enterprise, which makes studying its formal institutional changes worthwhile. Also, there is no doubt that early winners had decisive power on the path of reform, but that multiple reforms dismantled the institutional base of the winners’ coalitions. For this reason, this chapter will focus on the central state’s scheme to separate government agencies and businesses through multiple government organizational reforms and how this scheme has affected the implementation of industrial policy in the auto industry.

It is indispensable to understand the normative changes of value systems that support certain institutional arrangements in order to fully understand the institutional reforms at critical junctures. In this context, Eaton (2013, 2015) studied the politics of ideas about the rise of large enterprise groups (2013) and the advancement of the state (2015). Wang (2015) analyzed how

²⁵ For an effort to distinguish four major advocacy coalitions in China’s economic governance arena, see Heilmann and Shih (2013).

financialization of economic management by state and para-state actors was normalized during the early 1990s. This chapter, however, limits its scope to the trajectories of central government organizations, because “as a result of both high political uncertainty of the situation and the nature of the interaction itself, the outcome does not reflect the preferences of any of the key actors involved in the institution-making process” (Capoccia 2015, 161). Capoccia suggested two analytical steps in this situation:

first, carefully unpacking the actual impact that objective macrostructural conditions have on the influence of political actors and organizations; second, focusing at close range on political agency and interactions (*the politics of institution making*) and the institutional outcome of the process. (161–162, original emphasis)

Proceeding from here, this chapter first briefly describes the changing mode of industry management and principal actors involved in this transition. Section 3.2 follows how industrial governance in the auto industry has changed from 1982 to the present. The final section (3.3) analyses the dilemma between government institution building and effective industrial policy implementation.

3.2 Managing Industry: How and by Whom?

Since China embarked on economic reform, major governmental organizational reforms have coincided with the new terms of the State Council in 1982, 1988, 1993, 1998, 2003, 2008, and 2013. With almost a hundred ministries and special organizations under direct supervision of the State Council before 1982, simplification (*jingjian*) of government agencies became an important agenda item. As Table 3-1 shows, after various government reshuffles, the overall numbers of

central organizations and central government employees were reduced by more than half. From the beginning of the Chinese reform, top planners recognized the necessity of separation between government and business. On October 20, 1984, the third plenary session of the 12th CCP Central Committee officially affirmed *zhengqi fenkai* (separate government and business) as the direction of future economic system reforms.²⁶ The separation between government and business later expanded to separation between “government and assets” (*zhengzi*) and “government and society” (*zhengshe*).

Table 3-1. Changes in Numbers of Central Ministries, State Council Supervising Special Organizations, and Personnel

| Year | 1982 | | 1988 | | 1993 | | 1998 | | 2003 | | 2008 | |
|-----------------------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|
| | Before | After | Before | After | Before | After | Before | After | Before | After | Before | After |
| Number of Ministries | 52 | 43 | 45 | 41 | 42 | 41 | 40 | 29 | 29 | 28 | 28 | 27 |
| Special Organizations | 43 | 15 | 22 | 19 | 19 | 13 | 13 | 17 | 17 | 18 | 18 | 15 |
| Personnel* | 51 | 39 | 52 | 42 | 37 | 29 | 33 | 16 | 29 | 28 | 28 | 27 |
| % of Decrease | 23.5 | | 19.2 | | 21.6 | | 51.5 | | 3.4 | | 3.6 | |

* Unit: 10,000

Source: Wang (2008, 102–3); revised

In China’s Soviet-style planning period, the central economic agencies were largely composed of two different types, comprehensive and specialized. Table 3-2 captures the changing trajectories of the comprehensive and specialized economic agencies related to the auto industry from 1982 to 2014. The State Planning Commission (SPC) and the State Economic Commission (SEC) had been two important pivots of economic policy making. In the period of Soviet-style administrative resource management, the SPC set the imperative plans and the SEC

²⁶ “Decision of the Central Committee of the Communist Party of China on Some Issues concerning the Economic System Reform,” October 20, 1984.

was responsible for distributing targets to individual governments and SOEs through ex ante coordination. After the reforms began, the State Commission for Restructuring of the Economic System (SCRES) was added as another pivot to function as a kind of “think tank” to guide the direction of economic reform (Liu 2014, 40–44). While these three commissions were comprehensive economic agencies, eight different additional ministries supervised individual industries, such as machine and electronics, nuclear, aviation, radio electronic, ordnance, shipbuilding, aerospace, and agriculture machine industries.

Table 3-2. Reshuffles of Comprehensive and Specialized Economic Agencies, 1982–2014

| Year | 6th State Council | | | | | 7th State Council | | | | | 8th State Council | | | | | 9th State Council | | | | | 10th State Council | | | | | 11th State Council | | | | | | | | |
|---------------------------------|---------------------------------|----|----|----|----|-----------------------------------|----|----|----|----|--|----|----|----|----|---------------------------------|----|----|----|----|--|----|----|----|----|---|----|----|----|---|--|--|--|--|
| | 82 | 83 | 84 | 85 | 86 | 87 | 88 | 89 | 90 | 91 | 92 | 93 | 94 | 95 | 96 | 97 | 98 | 99 | 00 | 01 | 02 | 03 | 04 | 05 | 06 | 07 | 08 | 09 | 10 | 14 | | | | |
| Comprehensive Economic Agencies | State Economic Commission (SEC) | | | | | | | | | | | | | | | State Planning Commission (SPC) | | | | | State Development Planning Commission (SDPC) | | | | | National Development and Reform Commission (NDRC) | | | | | State-Owned Assets Supervision and Administration Commission (SASAC) | | | |
| | State Economic Commission (SEC) | | | | | | | | | | | | | | | SC Production Office | | | | | State Economy and Trade Commission (SETC) | | | | | LEWC | | | | | CEWC | | | |
| | State Economic Commission (SEC) | | | | | | | | | | | | | | | SC Production Office | | | | | State Economy and Trade Commission (SETC) | | | | | SC RES Office | | | | | State Development Planning Commission (SDPC) | | | |
| | State Economic Commission (SEC) | | | | | | | | | | | | | | | SC Production Office | | | | | State Economy and Trade Commission (SETC) | | | | | SC RES Office | | | | | State Development Planning Commission (SDPC) | | | |
| Specialized Economic Agencies | Ministry of Machine Industry | | | | | State Machine Industry Commission | | | | | Ministry of Machine and Electronics Industry | | | | | Ministry of Machine Industry | | | | | SETC State Machine Bureau | | | | | Ministry of Information Industry | | | | Ministry of Industry and Information Technology | | | | |
| | Ministry of Machine Industry | | | | | State Machine Industry Commission | | | | | Ministry of Machine and Electronics Industry | | | | | Ministry of Machine Industry | | | | | SETC State Machine Bureau | | | | | Ministry of Information Industry | | | | Ministry of Industry and Information Technology | | | | |
| | Ministry of Machine Industry | | | | | State Machine Industry Commission | | | | | Ministry of Machine and Electronics Industry | | | | | Ministry of Machine Industry | | | | | SETC State Machine Bureau | | | | | Ministry of Information Industry | | | | Ministry of Industry and Information Technology | | | | |
| | Ministry of Machine Industry | | | | | State Machine Industry Commission | | | | | Ministry of Machine and Electronics Industry | | | | | Ministry of Machine Industry | | | | | SETC State Machine Bureau | | | | | Ministry of Information Industry | | | | Ministry of Industry and Information Technology | | | | |

Ministries
 Bureau under State Council
 CCP Working Committee
 State Council Supervising Special Organization

Note:

SC RES Office: State Council Restructuring Economic System Office (*Guowuyuan jingji tizhi gaige bangongshi*)

SC Production Office: State Council Production Office (*Guowuyuan shangchan bangongshi*)

LEWC: Large Enterprises Working Committee of the CCP Central Committee (*Zhongyang daxing qiye gongzuo weiyuanhui*)

CEWC: Central Committee of the CCP Enterprises Working Committee (*Zhonggong zhongyang qiye gongzuo weiyuanhui*)

Source: *Guojia Renwen Lishi* (2014, 69–72); State Commission Office for Public Sector Reform (SCOPSR 2011); revised by author.

As mentioned in Chapter 2, the SETC document (2013) categorized two different modes of industry management: *bumen guanli* (management by government sector) and *hangye guanli* (management by industry). As all factories were regarded as the government sector (*bumen*) during the planning period, management style during this period was called management by government sector. As shown in Table 3-3, during the planning period, supervisory bureaucracies were the sole principal agents of management, and enterprises were part of their affiliated governments. The management purview of supervisory units was strictly limited to the affiliated firms. Figure 3-1 shows the position of state-owned banks and enterprises in the state structure during the 1980s.

Table 3-3. Different Features of Management by Government Sector (*Bumen Guanli*) and Management by Industry (*Hangye Guanli*)

| | Management by Government Sector | Management by Industry |
|---------------------------------------|--|--|
| Base of Economic System | Planned Economy System | Market Economy System |
| Base of Enterprise Institution | Unity of government and enterprise | Separation of government and enterprise |
| Principal Agent for Management | Government administrative units | Government industry management units and nongovernmental industrial association |
| Object of Management | Enterprises directly affiliated with the unit | Same type of products in whole society |
| Boundary of Management | Enterprises affiliated with the units and region | Systemic coordination over the same type of products in whole society |
| Features of Management | Direct management | Indirect management |
| Methods of Management | Orders issued through administrative channels | Industrial policy and legal methods as the primary tools, and necessary administrative methods |

Source: Bureau of Economic Operation, SETC (2003, 171)

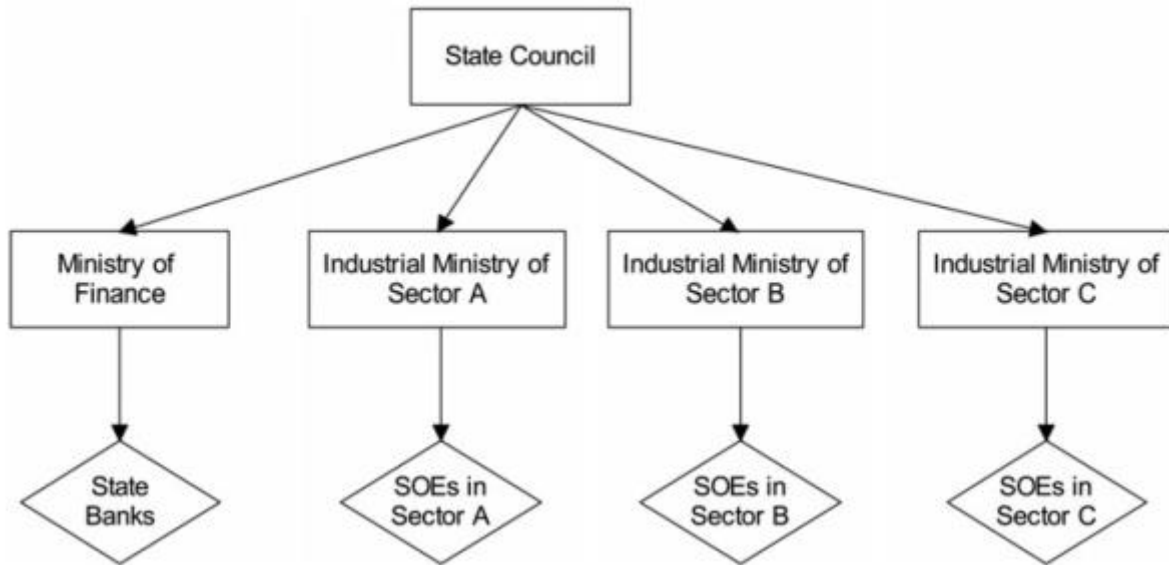


Figure 3-1. Management by government sector (*bumen guanli*).

“Positions of SOEs and state-owned commercial banks in the state structure in the 1980s before industrial ministries were abolished (black arrows represent administrative and supervising ties). Note that industrial ministries and SOEs under their supervision were divided by sectors.”

Source: Wang (2015, 615)

If the Chinese SOEs and state banks were managed in the way described in Figure 3-1, creating *zhengqi fenkai* would not be a very difficult task. The Ministry of Finance in the banking sector, and branch ministries in industrial sectors mediate between state council and state banks and SOEs. Therefore, SOEs could be set free by abolishing intermediary branch ministries. However, separation between state and businesses is not that simple. The organizational structure suggested by the management by government sector model (*bumen guanli*) is not the case in China, but is closer to the situation that existed in Eastern Europe and the Soviet Union, which was called “unitary hierarchical structure based on functional or specialization principles” (the U-form) (Qian and Xu 1993). In this U-Form system, “most enterprises were grouped by industry and under the direct supervision of ministries, and regional governments were primarily subordinates of the centre and their roles were limited to collecting

information from below and implementing plans from above without much autonomy” (143). The Chinese economy, however, was organized into a multilayer-multiregional form (M-form), which operated “mainly according to territorial principle, in which each region at each layer can be regarded as an operating unit” (144). Qian and Xu also present an example from the Chinese auto industry to explain the Chinese M-form economy:

In the automobile industry, almost all enterprises in Eastern Europe and the Soviet Union were directly controlled by the central government and the number of the enterprises was rather small. In China, there were 58 enterprises making automobiles before the reform, and most of them were controlled by the local governments (Wang and Chen 1991). Consistent with this, the number of products directly under the central plan in China was much smaller, only 791 in 1979 (Zhu 1985), as compared to more than twelve million in the former Soviet Union in the late 1970s (Nove 1980). (Qian and Xu 1993, 144)

To make matters worse, auto enterprises were not only segregated by territorial principle (*diqu fenge*), but also scattered throughout diverse sectors. Around the early 1980s, more than 10 sectors were involved in auto manufacturing, refurbishment, and parts. Hence, auto plants were dispersed in diverse local areas as well as sectors, and had individually complex affiliations (*lishu guanxi*), financial channels (*caizheng xiangjiao qudao*), and ownership types (*suoyouzhi xingzhi*). In this situation, some institutional conditions had to be met in order to separate the enterprise from the state. First of all, because auto plants were dispersed across various local areas and diverse sectors, establishing management by sector, as shown in Table 3-3, was a kind of prerequisite to proceed with *zhengqi fenkai*. SOEs should be able to operate as more

independent entities. Second, once SOEs become independent entities, branch ministries that are supposed to supervise designated sectors also need to sever their direct links with individual SOEs. Finally, comprehensive economic agencies, especially the State Planning Commission and State Economic Commission, must also change their roles and establish new relationships with SOEs.

Such a transition, however, entails interconnected changes in principal government agencies, policy goals, boundaries between state and business, and methods of industry management. China's post-Mao reforms no longer adopted Maoist radical revolutionary methods, but progressed in more incremental and recurrent ways. As a result, changes in government responsibility and institutions have kept bouncing back and forth. One reform measure often seems to contradict the previous one, but analyzing long-term trends reveals a hidden logic of the continuing reforms. In the next section, we look at what institutional changes have occurred in the industrial governance of the Chinese auto industry in three different eras.

3.3 Historical Evolution of Industrial Governance in the Chinese Auto Industry

3.3.1 Emancipating enterprises from administrative shackles, 1982–1993

Even during the Maoist period, most industries in China were not centrally managed, as depicted in Figure 3-1. Former Premier Liu Shaoqi attempted to form industrial trusts in 12 industries to overcome *tiao-kuai* partition in 1964, but Liu's fall during the Cultural Revolution led to the breakdown of the industrial trusts and the delegation of the management of enterprises to mostly local governments and central branch ministries as well (Chen 2005, 302). Due to failed attempts to centralize industrial management as in Eastern Europe and the Soviet Union, the *tiao-kuai* partition remained, and it has severely restricted the efficiency of resource allocation and

management flexibility. Chen Zutao's recollections well illustrate the situation during the period from 1982 to 1993:

The rigid management system restricted managerial and technical managers' initiative and vitality, and it made them not think about problems, but just follow advice from above. In this kind of management system, how can enterprises have vitality? Next to the engine laboratory of the Second Auto Works (SAW; *Erqi*), there was a water tower that had an oil tank on the top of the tower. The oil tank was very dangerous and also caused deaths in fire accidents. I proposed removing it and rebuilding it as an underground oil tank, which required increasing the area more than 60 square meters. If it were today, this might be a simple matter. A word from the top manager would suffice to solve the problem. However, at that time, the process was too complicated. I was the chief engineer and I wanted to remove it, but I did not have the power to change the design. No matter what I said, it was no use. Hence, I started looking for other people in charge: first, I invited Li Zizheng, our SAW deputy secretary, and Wang Jinren, SAW's deputy secretary in charge of infrastructure; then, deputy secretary of the Municipal Party Committee, deputy secretary of the installation company, and finally one secretary of the construction unit. I met five secretaries in total. Although they also agreed to the demolition, nobody could take initiative, but had to wait for the decision from the State Planning Commission. In this helpless situation, I rushed to thousands-of-miles-away Beijing to find a director of the SPC. After I explained it clearly to him, he signed the agreement, and then we could demolish and rebuild the oil tank. Is not the director of the enterprise who understands the

situation better in this kind of matter? There are so many companies all over the country, and if a person who does not understand the actual situation of the company makes the decisions, then can any company actively work? It wasn't limited to the oil tank problem alone, but happened in all of the processes of production and construction, such as minor changes to a design, the adjustment of production layout, the revision of industrial processes and so on; all needed to be reported and get approval. (Chen 2005, 273; my translation)

To remedy such chronic problems, the Chinese party-state decided to separate enterprise from administrative channels to improve enterprise's vitality. This overall direction of economic reform was also reflected in the auto industry. The auto industry, along with petroleum, shipbuilding, and metallurgy industries, was chosen as one of the pilot industries for the industry management system (SETC 2003, 179). For the reform of the automotive industry management system, the first step was issuing a guiding document, "Nationwide Automotive Industry Adjustment Plan (Implementation)," by the National Commission of Machine Industry in 1980. Following the plan, the China National Automotive Industry Corporation (CNAIC; *Zhonguo qiche gongye gongsi*) was established in 1982.²⁷ A general management responsibility system under the leadership of a board of directors was adopted and implemented in the CNAIC. A three-level management structure was designed: a board of directors as the highest echelon; CNAIC as the middle echelon; and seven jointly managed companies (*lianying gongsi*) as the lower echelon, which were Dongfeng, Nanjing, Jiefang, Zhongxing, Shanghai, Jingjinbei, and a supply company. At the opening ceremony of the CNAIC on May 6, 1986, then-Vice Premier

²⁷ Petroleum, shipbuilding, and metallurgy industries also established administrative corporations as intermediate organizations to separate government from business. The specific authorities and names differed.

Bo Yibo spoke of how establishing the CNAIC was an important breakthrough in China's economic management system, because it replaced business management, which had been done by the administrative organizations, with *economic organizations* for the first time (Chen 2005, 303).

Far from vitalizing enterprise, however, the CNAIC, at the middle of the three-level hierarchy, became the "small Ministry of Industry." The board of directors was supposed to supervise the CNAIC, but it had no power, and never even held meetings. The initial purpose of the reform was to vitalize the enterprises at the lower level, but the reform reinforced the power of the CNAIC by placing it between the insubstantial board of directors and the loosely organized joint companies. The CNAIC was awarded vice-ministry level administrative ranking (*jibie*) and enjoyed independent mandates over external affairs, planning, finance, and personnel (Chen 2005, 303). While the reform intended to change companies from the "state's product line" to the principal agents of the market, it ended up building corporations in name, but a "Ministry of Automotive Industry" in fact.

Shortly after the establishment of the CNAIC, members of both upper and lower echelons strongly criticized the excessive concentration of power in the CNAIC. In July 1984, the leadership of First Auto including Xu Yuancuan, the party secretary of First Auto, and Huang Zhaoluan, plant manager, sent a letter to the CCP central leadership. The letter criticized the current automobile industry management system and argued that the companies should be the entities that enjoyed independent management rights, not the CNAIC. The letter attracted great attention from the central leadership. In August 1984, the Central Finance and Economy Leadership Small Group held a conference on automotive industry development. One of the central leaders criticized the CNAIC and said: "CNAIC, you guys are trying to monopolize!"

(Zhang 2014). The pressure from both upper and lower echelons urged another reform on auto industry management. The basic direction of change loosened the relationship between the CNAIC and the seven joint companies by making the CNAIC hollower and weaker as an entity. The central leadership suggested making the CNAIC a service company, proposing the possible name, “Chinese Automotive Industry Joint Service Corporation” (*Zhongguo qiche gongye lianhe fuwu gongsi*).

Further reform measures aiming to weaken the power of the CNAIC and strengthen the joint companies’ autonomy had been started with a relatively long transitional period. In October 1986, the State Planning Commission designated Jiefang (First Auto), Dongfeng (Second Auto) and Zhongxing as discrete planning (*jihua danlie*) units. This meant the three companies did not have to account to the CNAIC anymore. In 1987, bolder actions were taken. At the upper echelon, the State Council directly engaged in the auto industry by organizing the Automotive Industry Leading Small Group, composed of leaders from the State Council, National Machine Commission, and the China National Automotive Industry Alliance (CNAIA, *Zhongguo qiche gongye lianhehui*).²⁸ The Leading Small Group was expected to replace the board of directors of the CNAIC. At the middle echelon, the CNAIC was abolished and reorganized into the CNAIA. The expected role of the CNAIA was to function as a bridge and conveyer belt between state and business. The CNAIC had directly managed enterprises, but the CNAIA was not allowed to do that. Finally, while the power of the CNAIA was weaker, the joint companies were growing stronger, as they became a business group (*qiye jituan*) through horizontal alliances.²⁹ Internally,

²⁸ I use an abbreviation of the literal translation, CNAIA, although the organization continued to be known as CNAIC in English to maintain its international reputation as the national team of the auto industry.

²⁹ For detailed reports about building the business group in Jiefang and Dongfeng, see Hu, Wang, and Lan 1989 and Wang and Tu 1986.

the business group tightened its control over the subsidiary companies; and, externally, it secured management autonomy through discrete planning.

Despite remaining historical legacies, the business group became a relatively independent market agent through the 1987 reform measure. However, the reform faced another setback caused by the 1989 Tiananmen Incident. The tide of economic reform temporarily flew backward, and the CNAIC was revived again.³⁰ The backflow, however, could not re-insert the already detached business group into the part of government sector. After these seemingly capricious reforms, inchoate state-business relations made an appearance for the first time in PRC history. Many issues remained with these recurrent reforms, but it was the first step out of the planned economy system.

3.3.2 Building the socialist market economy, 1993–2002

Through the institutional reforms in the previous period, SOEs became more autonomous entities. The emergence of relatively autonomous enterprises became the basis of promoting management by industry. The socialist market economy promulgated in 1992–1993 anticipated enterprises becoming principal agents of market transactions. SOEs, however, were not completely separated from the government. In order to separate government and businesses, both comprehensive and specialized economic agencies had to change their roles with regard to SOEs.

In 1992, the 14th CCP Central Congress affirmed industrial policy as a pillar of macroeconomic control, and a turf war over who was going to hold the reins of industrial policy began. Following the decision of the 14th CCP Congress, another round of government organizational reform was implemented to meet the needs of the socialist market economy. After the 1993 government organizational reforms, the distinction between the two types of central

³⁰ Its Chinese name gained one more character, *zong*, or “comprehensive,” while the English name again did not change.

economic ministries, comprehensive and specialized, became much clearer. The 1993 reform, however, was merely a repackaging of existing ministries into two categories. The comprehensive group was composed of the successors of planning commissions, such as the SPC, the SETC, and the SCRES. The specialized group inherited the line ministries that had purview over particular industries such as the Ministry of Coal Industry, Ministry of Machine Industry, Ministry of Construction, and so on. Hence, the “regulating relationship” (*lishun guanxi*) between the comprehensive and specialized groups, as well as among planning bureaus within the comprehensive group, became a salient issue. As a result, when the central leadership determined to promote industrial policy, four central-level agencies, including the Development Research Center (DRC), SPC, SETC, and SCRES, jointly held an industrial policy roundtable meeting (*Jingji Yanjiu Cankao* 1993). Coordination among these four central agencies was required, because the DRC was the leading organ of research and the three other commissions were directly involved in drafting industrial policy. Thus, at the bureau level, each commission had its own department for industrial policy.³¹ (See Table 3-4.) To add to these difficulties, coordination among relevant specialized ministries also needed to be orchestrated.

³¹ As shown in Table 3-4, between 1993 and 1998, in addition to SETC and SPC, SCRES also had a specific department for industrial policy, named the Department for Comprehensive Planning and Pilot Experiments (Bureau of the Secretary General’s Office 1995).

Table 3-4. Shifting Competition in Industrial Policy and the Auto Industry, 1988–2012

| | Competing Agencies in Industrial Policy | Competing Departments (<i>si</i>) in Industrial Policy | Primary Agencies for the Automobile Industry |
|-----------|--|--|--|
| 1988–93 | SPC <i>foundational body</i> | Department for Industrial Policy | CNAIC (China National Automotive Industry Corporation, <i>Zhongguo qiche gongye gongsi</i> 1982) CNAIA (China National Automotive Industry Alliance, replaced CNAIC in 1987) CNAIC (<i>Zhongguo qiche gongye zonggongsi</i> , 1990) ³² |
| 1993–98 | SETC | Department of Economic Policy Coordination | Bureau of Auto Industry, MMB (established in 1993, and demolished in 1998) |
| | SPC <i>rival body</i> | Department of Long-term Planning & Industrial Policy | |
| 1998–2003 | SETC | Department for Industrial Policy | Bureau of Machine Building (established in 1998, transferred to the command of the SETC in 2001) |
| | SDPC <i>shadow bodies</i> | Department for Economic Prognostics (1998–2001) Department for Industrial Development (2001–2003) | |
| 2003–08 | NDRC | Department for Industrial Policy | |
| | NDRC <i>rival body</i> | Department for Industry | |
| 2008–12 | MIIT | Department for Industrial Policy | Department of Equipment Industry, MIIT |
| | NDRC <i>dominant body</i> | Department for Industrial Coordination | |

Note: NDRC (National Development and Reform Commission, 2003–current), MIIT (Ministry of Industry and Information Technology, 2008–current), MMB (Ministry of Machine Building, 1993–8), SPC (State Planning Commission, 1954–98), SDPC (State Development Planning Committee, 1998–2003)

Source: Compiled by the author from Heilmann and Shih (2013, 11); Zhao (2000, 231); Liu; Feng, Yang, Qian, Liang, Li, Lai, and Shi (2003); CAAM (2006, 130–134); and the Bureau of the Secretary General’s Office and SCOPSR (1995, 1998, 2003, 2008).

On September 12, 1997, the CCP party secretary Jiang Zemin, in his report to the 15th CCP Congress, harshly criticized its bulky organization and personnel, nonseparation of politics and

³² The early reform of the CNAIC to the CNAIA was intended to reduce the government’s direct involvement in the auto industry, but faced a setback when economic reforms were reversed temporarily after the 1989 Tiananmen Incident. For a detailed history of this period, see Chen (2005, 271–313).

business, and severe bureaucratism as hindrances to the deepening of reform and economic development. Following the party's direction, another round of massive government organizational reform was initiated. After this 1998 reform, the number of central ministry-level organizations was drastically reduced from 40 to 29 (Table 3-1), which were streamlined into four different types of organizations: (1) macroeconomic control sectors; (2) specialized economic management sectors, which no longer were directly involved in enterprise management, but only guided coordination among industries; (3) science, technology and education, social welfare, and resource management sectors; and (4) government affairs sectors. In terms of economic management, this round of reforms emphasized the end of the government's direct intervention into corporations by separating the roles of players and referees. First of all, the SPC, renamed the SDPC, mainly took charge of long-term macroeconomic control. Second, the SETC took the responsibility for short-term economic management. The mandate of industrial policy was handed over to the SETC to facilitate more effective industrial management. It also absorbed most of the specialized economic organizations under its command as subordinate bureaus.³³ For instance, the Ministry of Machine Industry was relegated to the State Machine Industry Bureau and attached to the SETC. This reform measure was another step forward in separating politics and businesses by weakening and finally abolishing the specialized economic ministries. The Ministry of Machine Building's (MMB) total number of personnel once reached about 4,600, and it directly supervised more than 900 SOEs and 60 research institutes. These branch ministries were relegated to state bureaus under the SETC, which was planned to be abolished after only three years. Thus, the primary task of the bureau

³³ Namely, the (1) State Internal Trade Bureau, (2) State Coal Industry Bureau, (3) State Machine Industry Bureau, (4) State Metallurgy Bureau, (5) State Petroleum and Chemical Industry Bureau, (6) State Light Industry Bureau, (7) State Textile Industry Bureau, (8) State Construction Material Industry Bureau, (9) State Nonferrous Metal Industry Bureau, and (10) State Tobacco Monopoly Bureau.

was arranging former cadres' reemployment. The MMB's 308-member staff before the 1998 reform was cut to 105; because the bureau would fade away soon, only cadres close to retirement age remained in the office (Ji 2014). By completely abolishing the line ministries through this reform, the Chinese central state cut another link with SOEs. The line ministries were no longer allowed to be involved in the management of former SOEs. By making the SETC the control tower of short-term economic management, the reformers expected more harmonious coordination between different industrial sectors. (On the implications of establishing the SETC, see Jung 2008.)

Abolishing the line ministries and annexing them to agencies under the jurisdiction of the SETC prevented the anticipated resistance to the massive SOE reform, discussed in chapter 5. Demolishing the line ministries, however, left medium and large central SOEs abandoned. To make the SETC an impartial regulator, the SETC severed the official ties between the newly annexed former line ministries and SOEs, putting the SOEs in an awkward position. While the state nominally owned the SOEs, it was not clear which specific states owned which enterprises. In this circumstance, the Central Party made an appearance in the Large Enterprises Working Committee of the CCP Central Committee (henceforth LEWC) in July 1998 (Guthrie, Xiao, and Wang 2015, 82; Zhang and Yuan 2008, 97). Because there were no state bureaus that could function as owners of SOEs, the LEWC made direct appointments to fill the high-ranking posts of the central SOEs and coordinated SOE reform. The Central Committee of the CCP's apparent role in SOE reform had two different consequences. First, the direct supervision of the CCP Central Committee in SOE reform and the abolition of line ministries reduced the resistance to the SOE reform noticeably. Second, local government was empowered to manage SOE reforms at the respective local levels. Local government was able to enjoy much greater room to

maneuver because the LEWC only supervised large central enterprises that used to be under the control of central line ministries. But the party's direct involvement in the personnel matters of the central SOEs went against the spirit of the socialist market economy. More fundamental reform of state enterprises management system became unavoidable.

3.3.3 Rise of the shareholding state, 2003–present

Since 2003, the previous economic governance structure has been transformed into a totally new mode of economic management. After the line ministries were abolished through the relegation of their responsibilities to the SETC, it became an urgent task to find a viable mechanism of state control for SOEs. The 2003 government reshuffle consolidated the Chinese industry management system to be run by the National Development and Reform Commission (NDRC; SPC's succeeding organization) and the State-Owned Assets Supervision and Administration Commission (SASAC) (Table 3-2; Lu and Cai 2010). Except for the Ministry of Information Industry, all branch ministries had been destroyed at the end of the Ninth State Council (1998–2003). The previous comprehensive economic agencies, SCRES, SDPC, and SETC, were finally merged into a single so-called “mini-State Council,” the NDRC (Gore 2012). The NDRC's missions encompass those of the three prior comprehensive economic agencies, such as strategic planning and macroeconomic regulation, orchestrating industrial policy and coordinating economic activities, and reforming the economic systems. The NDRC became a “visible hand in the market” with the emergence of “the state advances, the private sector retreats” (*guojin mintui*). On the foundation of the LEWC, the SASAC became the personified sole owner of central SOEs in the nonbanking sectors. By establishing the SASAC, the Chinese central government discovered financial mechanisms for state control of SOEs (Wang 2015).

A chained hierarchical ownership structure for the SASAC, parent company, and subsidiary companies in central SOEs became an efficient tool to control the central SOEs with minimal financial shareholdings. (See chapter 5 for details.) As shown in Figure 3-2, the SASAC is no longer constrained by sectoral segregation. The SASAC is the sole owner of the all central SOEs. The SASAC also owned industrial holding companies, such as the State Development and Investment Corporation (SDIC), and it indirectly controlled subsidiary SOEs.

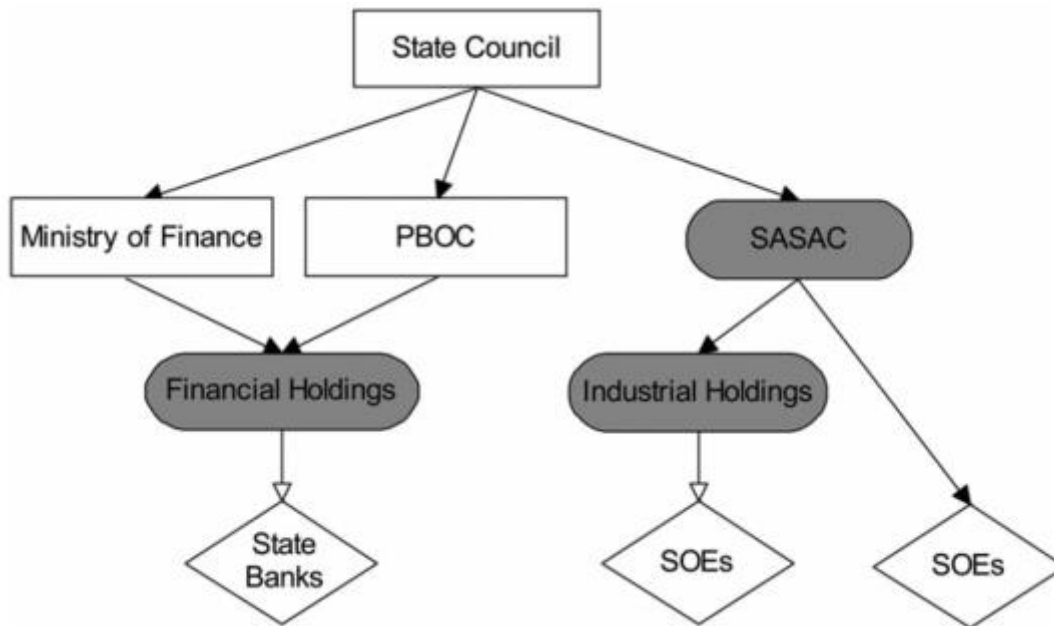


Figure 3-2. Management by shareholding state, 2003–current.

“Positions of SOEs and state-owned commercial banks in the state structure at present. Note that state asset management bodies (in ovals) constitute the intermediate structure that closed off sectoral divisions. White arrows represent ties of ownership.”; PBOC: People’s Bank of China.

Source: Wang (2015, 615)

In 2008, the Ministry of Industry and Information Technology (MIIT) reorganized as the major organization for industrial management. Although the MIIT merged with other related agencies, it was based on a transformation of the Ministry of Information Industry. The

reorganization of the MIIT was expected to fill the void left by the abolishment of the SETC.

[The central government, however, had already lost organizational capacity and cadres who had decades of experience interacting with SOEs; thus, establishing the MIIT was not enough to change the course of reform. Furthermore, the division of labor between the NDRC and the MIIT has not been clarified yet, so local governments play their own game by selectively utilizing project-screening authorities. According to one provincial-level government official at the Economic and Information Committee, once local governments finalize certain projects, they apply to either the NDRC or the MIIT to be ratified, choosing the one where they have a better chance of winning permission. Ratification from one organization can be a source of leverage on the other, so local governments frequently abuse the murky division of labor (interview, Oct. 10, 2013, Tianjin, China).]

3.4 Biased Preferences, Organizational Discontinuities, and Industrial Policy

Implementation

The organizational evolution of China's central state discussed in the previous sections has had significant influences on the central state's preferences for businesses and organizational capacities to implement industrial policy. Repeated government restructuring resulted in a lack of stable organization, and ended up causing the central government to lack both information and learning capability in regard to industries. According to a study on the empirical impacts of industrial policy by the Chinese Academy of Social Sciences, leaders' preferences have been neglected in the study of industrial policy. The study claims that leaders' career backgrounds and the personnel structures of agencies have huge influences on the objectives of industrial policy. For example, the Chinese National Automotive Industry Corporation (CNAIC) has had profound impacts on the processes of auto industrial policy making. All the top leaders of the CNAIC had

career backgrounds at the First Auto Works (FAW). Furthermore, all leading cadres at the bureau (*ju*) and department (*si*) levels were exclusively recruited from either the FAW or the Second Auto Works (SAW). Their careers at these central SOEs influenced their policy preferences, as expressed in diverse ways. Technically, the FAW and SAW specialize only in commercial and passenger vehicles, so agriculture vehicles were not on the agenda until the production volume of agriculture vehicles reached 2.6 million in 1996. Also, these leaders were accustomed to the working style in the SOEs, so when they were in policy-making positions, there was not enough consideration of market mechanisms (Zhao 2000, 122–123). The policymakers' preferences made a small number of SOEs to take advantage of the AIPs to gain favorable positions in finance and government procurement. When the Chinese central government first released its AIP in 1994, the policy designated a small number of large SOEs to be nurtured as national champions in the auto industry. These designated SOEs enjoyed exclusive preferential policy treatment including matching subsidies corresponding to production capacity, the right to form JVs with MNCs to acquire technical and financial support, and preferential treatment for government procurements (Fuller 2016; Huang 2003, 2008; Pettis 2013; Unirule 2011).

In addition to such biased preferences, the recurrent government organization reshuffles disrupted the historical, organizational, and biographical continuity of industrial policy agencies. In July 1994, the SPC issued the first AIP. Because three different comprehensive economic commissions (SPC, SETC, and SCRES) and one specialized ministry (MMB) had direct interests in the 1994 AIP, it was a difficult task to coordinate among the government agencies. To facilitate issuing the first industrial policy, the highest CCP-level Central Finance Leading Small Group issued an order about automobile industry development (*1995 Automotive Industry*

Yearbook, 11). The central leadership's direct involvement expedited the policy-making process, but the party was able to intervene only after multiple stakeholders had already distorted the original intention behind the industrial policy. In addition, after promulgating the 1994 AIP, the strict entry barrier was relatively well maintained until the SPC was responsible for industrial policy. But once the jurisdiction of industrial policy was transferred to the emerging, powerful State Economic and Trade Commission (SETC) in 1998, the controlling ability apparently diminished. The 1994 AIP stated that "the SPC is responsible for final interpretation" (article 61), but in 1998 the SPC was transformed into the State Development Planning Committee (SDPC), and the discretion for industrial policy became vested in the SETC between 1998 and 2003.

A decade later, in 2004, the central agencies drafted a new AIP. The 2003 government organizational reforms divided the central state's role into those of investor (SASAC: State-Owned Assets Supervision and Administration Commission), macroeconomic regulator (NDRC), and independent coordinator of commerce (Ministry of Commerce), in the style of a Western regulatory state. By separating the state's roles as owner and regulator, this organization seems to fulfill the minimal conditions for a level playing field. However, despite the organizational separation, the Chinese central state still was not able to keep an arm's length in its relations with SOEs. As a macroeconomic regulator, the NDRC drafted a new AIP in 2004. When the NDRC released the "Draft for Collecting Opinions," it said it was intended to collect views and suggestions from all the parties concerned. In May 2004, when the NDRC initially released it, the full draft went only to its "biological offspring": FAW, DMC (Dongfeng Motor Corporation, formerly SAW), SAIC (Shanghai Automotive Industry Corporation), and BAIC (Beijing Automotive Industry Corporation), with a clear warning of a strict ban on disclosure to the press. In contrast, the drafts issued to private auto companies only had a couple of titles without

contents (Hu 2003). This Chinese example of AIP preferences fits well with a description by Doner (1992, 400): “Autonomously developed preferences may reflect and enhance predatory behavior by state officials; instead of promoting innovations and productivity increases, such behavior can exacerbate informational difficulties.”

The reorganization of industrial management after 2003 also provoked new adverse effects on the implementation of industrial policy. As the SPC’s succeeding organization, the NDRC’s mission centers on the national economy and social development, rather than the development of individual industries. Furthermore, its major counterparts have been government units including ministries and local governments. As a result, the NDRC’s primary concerns are macroeconomic balances and screening projects (*xiangmu shenpi*). Because the NDRC manages industrial policy mainly by screening projects, local governments easily bypass investment regulation by adjusting the scale of their projects. The SASAC, as a state asset manager, also primarily cares about SOEs’ asset value. In the logic of industrial policy, enterprises should be considered mediums of organizational capacity, and the major policy goal should be to develop enterprises’ capacity. However, because the SASAC, along with the Organizational Department of the CCP, appoints managers to the top positions of large SOEs, the incumbents at large SOEs are concerned more about financial metrics than capacity building.³⁴ In the auto manufacturing SOEs that were the principal beneficiaries of the AIP, the top managers cared mainly about financial statements and their own promotion, and they preferred to expand joint venture operations with foreign partners over developing their own brands and models.

³⁴ In 2005, SASAC started to use “the rate of preserving and appreciating the value of state assets” for measuring SOEs’ performances (Wang 2015, 613).

3.5 Conclusion

China's economic control tower is far from being an internally cohesive and unitary agency like Japan's MITI or South Korea's Economic Planning Board (EPB). The frequent government organizational reforms seriously reduced government autonomy and dismantled institutional continuity, which are the minimum necessary conditions for effective industrial policy implementations. Government organization reform, simplified in terms of separation of state and business, resulted in the following negative effects on industrial policy. First, during the period before 1992, some government responsibilities for industry administration (*gongye xingzheng*) were delegated to an intermediate organization, which had a profound impact on industrial policy formulation after 1992. Second, government reorganizations to remedy the government's involvement in corporate management eventually abolished the State Economic Commission, which worked mainly with state enterprises, and strengthened the State Planning Commission, which worked mainly with government sectors including central specialized ministries and local governments. Overthrowing the organizations that had practical knowledge about the industry and close connections with businesses made it impossible to implement the goals set in the industrial policy. The planning commission, which is a new supervising department for industrial policy, traditionally worked with governments, and is not effective at much more than screening investment proposed by local governments. In addition, SASAC was established as the owner of state enterprises, and hence only cares about asset preservation and growth from the owners' perspective. Finally, recurrent government organization reforms resulted in the lack of stable organizational structure and led to the central state's lack of information and learning capacity in regard to industry.

CHAPTER 4

Reshaping State-Business Relations and the Emergence of a Dual Industrial Structure

4.1 Introduction

This chapter attempts to analyze how reforms of state-business relations affected the implementation of the auto industrial policy. Since embarking on the socialist market economy (SME) in the early 1990s, the Chinese central party-state has aggressively promoted a large-scale state-owned enterprise restructuring program, especially during the administration of Premier Zhu Rongji (1998–2003). In 1997, the 15th Party Congress put forth the policy of *zhuada fangxiao* (grasp the large, let go of the small) and this policy had a great impact on not only SOEs, but also private enterprises. The SOE reform before 1993 was intended to motivate the SOEs' performance by changing their incentive structure without fundamentally changing ownership structures. The SOE reforms in the period of SME, however, pursued (1) the adjustment of the public economy's industrial structure with (2) corporatization (*gongsihua*) of SOEs and (3) financialization of state-asset management (*guoyou zichan zibenhua*).³⁵ China's party-state grasped important industrial sectors and enterprises by designating “commanding heights” industries and backbone enterprises several times. The policies regarding structural adjustment reset the boundaries of the SOEs' dominance and indirectly set the scope of activity for non-SOEs. In addition, despite only very gradual progress towards the original goals, China's central party-state carried out corporatization of SOEs and financialization of the controlling

³⁵ For more detailed discussions of the meaning and progress of corporatization in China, see Naughton 2015 and Li 2015 ; 2016. For a general description of financialization, see Van der Zwan 2013, and for the financialization of China's economic management, see Wang 2015.

public economy. These institutional changes in governance directly affected the incentive structure of the SOEs' profit-seeking activities.

In analyzing China's incomplete transition to a market economy, previous studies have also noted continued party-state-business relations. The focal point of existing studies has been on whether the party-state was captured by the SOEs or vice versa in the course of reform (Brødsgaard 2012; Chan 2009; Heilmann 2005, 2006; Yang 2015). The CCP's tight control over personnel in important SOEs' top managerial positions through the *nomenklatura* system has received particular attention.³⁶ The *nomenklatura* system explains the "balance between economic decentralization and political coherence" (Heilmann 2005, 1) and "the coexistence of the contracting forces for further enterprise autonomy and continued central control" (Brødsgaard 2012, 624). Researchers have also looked at other aspects of government intervention in SOEs; for example, Yeo (2013) studied the party's creation of new corporate governance modes through the establishment of external boards of directors, and Li (2016) examined the CCP's role in the rise of central SOEs. While these studies have contributed to describing the concrete reality in China by going beyond normative approaches like the "transition orthodoxy" (Nolan and Wang 1998) or the "plan to market narrative" (Heilmann and Shih 2013, 21) mentioned in Section 1.4, they fail to show the big picture of structural change in state-business relations.

According to Capoccia (2015, 160–164), insitutional change at critical junctures can be explained in terms of three primary mechanisms: coalitional engineering, out-of-winsset outcome, and the politics of ideas. This chapter pay special attention to the politics of ideas on the relationship of public ownership and market mechanisms. Of course, Chinese reformers' ideas

³⁶ According to Brødsgaard (2009, 80), the *nomenklatura* system can be defined as "a list containing those leading officials directly appointed by the Party as well as those officials about whom recommendations for appointment, release or transfer may be made by other bodies, but which require the Party's approval."

are also open to contestation, and face opposition that inevitably leads to them being largely revised in the course of policy making and implementation. However, the identity of China, as a socialist country transitioning to a market economy, remains tied to socialism, whose role cannot be denied although it has been weakened. Hence, the details of China's market transition can be interpreted in light of its socialist identity. This chapter explains Chinese SOE reform after 1993 by paying close attention to the social contexts that have shaped the actors' identities. Top leaders' identities determine their ways of interpreting their current situations and their ways of doing things (Locke and Thelen 1995). According to Chen Li (2016, 4), when Vice-President Li Yuanchao (2013–present) was the head of the Organizational Department of the CCP Central Committee, he “stressed [that] ... the Party's leadership in the SOE sector should ‘never be weakened’” and that “it was critical to ‘*organically integrate*’ the party's leadership with the development of a modern enterprise system” (my emphasis). Moreover, Chen Qingtai, the deputy director of the Development Research Center of the State Council, defined the core of SOE reform as follows: “Ostensibly it [SOE reform] looks like an *efficiency problem*, but in substance it is about how the public and state-owned economy combine with the market economy” (Chen 2005, 2). In other words, the Chinese party-state has conducted various experiments to organically combine the public economy and the market economy while maintaining the party's control. Within this big picture, the SOE reform was carried out in two directions: through restructuring the industrial system and through creating a new SOE governance structure.

This chapter is structured as follows. The next section (4.2) explores China's unique understanding of the relationship between public ownership and market mechanisms. After that, section 4.3 examines how the Chinese central government proceeded to change the public

economy's industrial structure through selective retreat and concentration of state ownership. Section 4.4 analyzes how the vertical integration of planning and market mechanisms was embedded in the hierarchy of the party-state, SASAC, and the central SOEs. Section 4.5 scrutinizes the implications of SOE reform for the implementation of auto industrial policy, and section 4.6 concludes the chapter.

4.2 The Relationship of Public Ownership and Market Mechanisms

Expanding market mechanisms' role in resource allocation and strengthening the party-state's power to influence large central SOEs go side by side in contemporary China. How do these seemingly contradictory movements proceed together? The real practices of Chinese economic reform did not go hand in hand with political liberalization. The continuing socialist regime and guiding ideology provide unique solutions in the face of economic reforms. Over the two-plus decades since 1993, China's SOE reforms have actively combined corporatization (*gongsihua*) and financialization (*zibenhua*) based on Marxist theory. Faced with a bankruptcy crisis of the SOEs, the Chinese central party-state pursued institutional reforms that enabled it to strengthen its control over strategically important SOEs and transform its total liability for the SOEs to limited liability. The majority shareholders of corporations enjoy both "contractual rights" and "property rights," which allows companies to avoid responsibility when exercising property rights (Kim 2013, 2015, 2016).³⁷ China's corporatization of the SOEs, despite being a long, dragged-out process, has worked toward converting the form of state-owned assets from enterprises (*qiye*) to capital (*ziben*). This transition has led naturally to the financialization of the management of state-owned assets. Financialization is broadly defined as "the increasing role of

³⁷ Section 4.4 discusses Chinese corporatization reform, but for more detailed discussions, see Hassard et al. 2007; Lin and Zhu 2001; Oi 2011; Zhang 2008.

financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies” (Epstein 2005, 3). For corporatized state-owned assets, the government no longer directly manages the enterprises, but exercises “property rights” as the largest shareholder. Yingyao Wang (2015) described this new role of the government as a “shareholding state,” which is “embodied presently in a proliferation of ‘personified’ state shareholders and institutional owners who exist between the abstract state and operative SOEs” (608).

In order to induce corporatization and financialization, the party continually provided opinions on how the relationship between the public economy and the market economy should be formed. As early as 1993, a decision of the third plenary session of the CCP suggested “actively explor[ing] the rational forms and ways of state-owned assets management.” In 1997, the 15th National Congress of the CCP further pointed out that “we should try to find a form of public ownership that can greatly promote the development of productive forces.” In 2002, the 16th National Congress of the CCP reiterated that “we should further explore the multiple effective forms of public ownership, especially the state-owned system.” The third plenary session of the 16th CCP Central Committee in 2003 further emphasized that the state should “actively explore effective forms of supervision and management of state-owned assets.” The fifth plenary session of the 18th CCP Central Committee in 2015 stressed the need to “deepen the reform of state-owned enterprises, and enhance the vitality of state-owned economy, control, influence, and anti-risk ability ... [and to] improve the management system of various types of state-owned assets, and strengthen supervision over *capital-based state-owned assets management* to prevent the loss of state assets” (my translation and emphasis).

Instead of following the “transition orthodoxy” discussed in chapter 1, the CCP never allowed market mechanisms to replace the old system, only gradually allowing them to work in ways that maintained the CCP’s control and increased productive forces. However, control and effectiveness are hard to achieve at the same time, if not entirely incompatible. Thus, the Chinese central leadership employed a strategy of selection and concentration to chase two hares at once. First of all, while decreasing the projected scope of public ownership, a series of reforms aimed to increase the influence of SOEs in strategically important areas (section 4.3). Second, by redefining public ownership through corporatization and financialization, the Chinese top-level reformers created a hierarchy in which public ownership was at the top and other, diverse types of ownership were at the bottom. This hierarchy seems to correspond with Chinese reality as well as classical Marxist theory. Li Rongrong, the founding director of SASAC, elaborated on the Chinese socialist economic base by citing a 2000 speech by Jiang Zemin entitled “Consolidating and Strengthening the Socialist Economic Base”:

In our country, the CCP is the governing party, which guides the people and exercises the power of the state. Our socialist state regime needs to be an efficient operation and should hold the reins in certain economic and material capacities. ... Without a public economy that consists of the state-owned economy as the core, there would be no socialist economic basis: neither the reign of the CCP nor the overall socialist superstructure’s economic base and strong material means. Of this point, leading cadres at various levels, especially high-ranking cadres, must be clearly and soberly aware. (Jiang Zemin, quoted by Li 2013, 3; my translation)

Jiang Zemin's speech made a direct link between the economic situation of China and Marxist theory. To uphold the CCP's political monopoly, there had to be enough material support from the substructure. Public ownership and the nonpublic economy, however, have distinct roles. Public ownership is good at representing the advantages of a late-industrializing country, as suggested by Alexander Gerschenkron (1962), as well as at realizing independent development and protecting national economic security. On the other hand, the "nonpublic ownership economy," which is equivalent to a market economy mainly driven by private actors, is favorable for promoting market competition, upgrading industrial structure, implementing innovations in industrial structure, quickly developing the national economy, introducing advanced technology and management skills, and cooperating with global markets (Li 2013, 3–4).

After 20 years of experience of the socialist market economy, the third plenum of the 18th Central Committee of the CCP in 2014 finally named China's realized mode of basic economic institutions a "mixed ownership economy" (*hunhe suoyou jingji*).³⁸ A mixed economy in capitalist countries means a linkage between different forms of private capital, and it aims to smooth and eradicate crises resulting from the fundamental contradictions of capitalism. In contrast, a socialist mixed ownership economy means an alliance of public ownership, which is located in the principal position, with a nonpublic economy that is utilized to increase productive forces (Jia 2014, 7). Jia Huaqiang, a professor of the Central Party School, found a theoretical reference for "mixed ownership" in Marx and Engels's *Communist Manifesto*:

³⁸ For in-depth debates on the "mixed ownership economy" in Chinese, see Chang 2014, Jia 2014, Ju 2014, Qiu 2014, Tian and Liu 2014, and Xie 2014.

The proletariat will use its political supremacy to wrest, by degrees, all capital from the bourgeoisie, to centralize all instruments of production in the hands of the State, i.e., of the proletariat organized as the ruling class; and *to increase the total productive forces* as rapidly as possible. (my emphasis)

In Jia's (2014, 3) interpretation, prioritizing public ownership is a way of centralizing the instruments of production in the hands of the state; furthermore, by following the direction of the *Communist Manifesto*, the CCP allows diverse ownership structures to increase the country's total productive forces. According to Jia, because history shows that a maturing commodity economy and a market economy cannot be transcended, pluralized agents with different ownership types must be allowed.

4.3 Adjustment of the Public Economy's Industrial Structure

The SOEs' total debt ratio, which is the ratio of total assets and total debt, increased 75% in 1995 (*People's Daily* 1996, May 9). As Figure 4-1 shows, the total deficit ratio also dramatically increased after the 1990s. The state had unlimited liability for SOEs, so heavily debt-ridden SOEs drove the state into a dangerous situation.

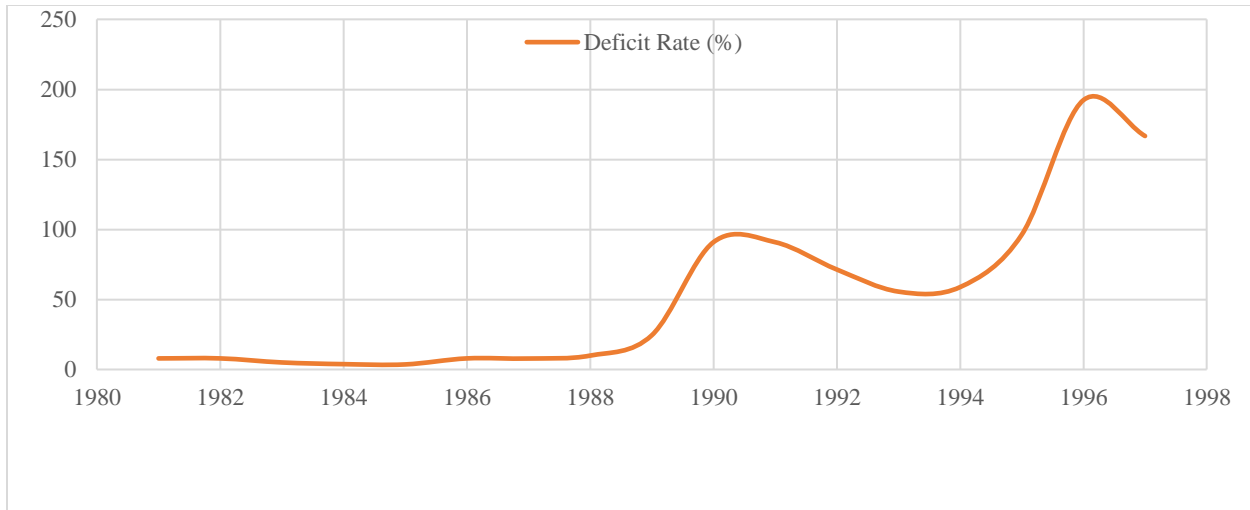


Figure 4-1. Trends of SOE deficit rates (%), 1981–1997.

Source: Zhang and Yuan (2008, 90).

Note: Deficit rate = (total amount of deficit / total amount of profit) * 100.

As a first step to overcome the large-scale debt situation, the central party-state rebalanced the distribution of industries in which SOEs were concentrated. The fourth plenary session of the 15th CCP Central Committee in 1999 specified the following four sectors as the industries that the state-owned economy needed to dominate: (1) industries involving national security; (2) industries with natural monopolies; (3) industries that provide important public goods and services; and (4) key enterprises in pillar industries and high-tech industries. The first three categories include the entire industries as the sectors that the state needed to control, but the last category only covers the most important companies in the pillar and high-tech industries. In a pillar industry such as the auto industry, apart from a few key corporations, small enterprises were designated for *fangxiao*, “let go of the small.” The overall rebalancing of the industrial distribution of SOEs has had two important implications for the pillar industries. First of all, many SOEs in the first three categories were engaged in high-profit industries outside of their major business areas. For example, many military and ordnance SOEs had expanded into other lucrative sectors such as hotels and automobiles. The monopoly status of SOEs in the first three

categories ultimately led them to focus on their main business areas. In the end, the companies that were operating beyond their main business areas were selected for sale. Second, the central party-state explicitly proclaimed that a few core enterprises (*gugan qiye*) in the sectors of the fourth category would be their targets: *zhuada*, “grasp the large.” Declaring that the central government would focus on only a few important companies likely acted to neutralize the entry control enforced by industrial policy.

In December 2006, the SASAC announced a new policy to strengthen the state’s control of the public economy. It required the state-owned economy to maintain absolute control over seven strategic industries and relatively strong control over key enterprises among nine other industries (See Table 4-1).

Table 4-1. SASAC’s New Guidelines for National Economic Control, 2006

| Level of State Control | Major Targets | Specific Industries |
|------------------------|---------------------------------|--|
| Absolute | 7 industries | Military, power grid and power generation, petroleum and petrochemical, telecommunication, coal, civil aviation, and shipping |
| Relatively strong | Key enterprises in 9 industries | Equipment manufacturing, automotive, digital information, construction, steel, nonferrous metals, chemical, exploration and design, science and technology |

These new guidelines were an extended version of the 1999 CCP decision. With the establishment of the SASAC in 2003, the SOEs specified in Table 4-1 were reorganized as centrally controlled enterprises (*zhongyang qiye* or *yangqi*). The number of these has been continuously decreased (see Table 4-2), reaching 102 as of August 2016. Table 4-3 shows the number of *yangqis* by industry, along with their income and profit, as of 2010. The seven industries that are absolutely state-controlled have higher profit margins due to their monopolies. For example, the three *yangqis* in the petroleum/petrochemical sector (CNOOC, CNPC, and

China Petrochemical Corporation) account for about 31.74 percent of all the *yangqis*' net profits as of 2010. (See chapter 6 for more detail.) According to Zhang Hanya, vice president of China Investment Association, in the monopolistic industries in China at present, the proportion of private capital entry does not exceed 20%. Of the 80 industrial sectors in the whole society, 72 allow the entry of state-owned enterprises, 62 allow the entry of enterprises with foreign investment, but only 41 allow entry by private-sector enterprises (Liu 2010).

Table 4-2. Number of Centrally Controlled Enterprises (*Yangqi*), 2005–2013

| Year | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|----------------------|------|------|------|------|------|------|------|------|------|
| No. of <i>yangqi</i> | 166 | 162 | 155 | 148 | 129 | 120 | 117 | 115 | 113 |

Source: Chen and Zhao (2014, 38); revised by author.

Table 4-3. *Yangqi*: Industries, Numbers, Total Operating Incomes, and Profits in 2010

| Industry | Number of Enterprises | Total Income | | Total Net Profit | |
|-----------------------------------|-----------------------|--------------|------------|------------------|------------|
| | | Billion RMB | Proportion | Billion RMB | Proportion |
| Petroleum and petrochemical | 3 | 4044.69 | 24.1% | 270.54 | 31.7% |
| Steel | 3 | 615.25 | 3.7% | 26.29 | 3.1% |
| Power grid and generation | 9 | 2772.58 | 16.5% | 72.11 | 8.5% |
| Machinery equipment manufacturing | 12 | 713.39 | 4.3% | 48.35 | 5.7% |
| Construction | 8 | 1987.52 | 11.8% | 44.07 | 5.2% |
| Telecommunication | 3 | 956.23 | 5.7% | 103.16 | 12.1% |
| Civil aviation | 3 | 241.07 | 1.4% | 23.52 | 2.8% |
| Shipping | 3 | 323.61 | 1.9% | 23.07 | 2.7% |
| Trade | 19 | 1746.09 | 10.4% | 33.94 | 4.0% |
| Subtotal | 63 | 13400.43 | 79.9% | 645.05 | 75.7% |
| Other | 57 | 3376.51 | 20.1% | 207.22 | 24.3% |
| Total | 120 | 16776.94 | 100% | 852.27 | 100% |

Source: SASAC Financial Supervision and Evaluation Bureau (October 2011), cited by Chen and Zhao (2014, 39–40); revised by author.

4.4 Embedding Vertical Integration of the Planned Economy and Market Mechanisms

The large SOEs targeted for state control have continuously been subjected to state-initiated pilot projects, such as those experimenting with “large corporations, large business groups” (*dagongsi*, *dajituan*); a modern enterprise system (*xiandai qiye zhidu*); business groups (*qiye jituan*); and a shareholding system (*gufenzhi*). The main purpose of these experiments has been to test the effects of new institutional devices. The central party-state has searched for innovative institutions that can enhance the central government’s capacity for control while enlarging the SOEs. The corporatization (*gongsihua* or *gongsizhi gaige*) of traditional SOEs has been at the base of numerous experiments. Corporatization, however, has been a prolonged process.³⁹ About corporatization in China, Naughton (2015, 54) wrote:

“Corporatization” (*gongsihua*) came to the Chinese economic reform process in 1993, at the beginning of the 1990s era of reforms. A reform blueprint in that year called for the adoption of a “modern enterprise system,” a euphemism for corporatization. The Company Law came into effect in July 1994, and under this Law traditional state-owned enterprises were to be reorganized into one of a variety of corporate forms. The creation of a joint stock company listed on the stock exchange was the most thorough option, but enterprises could also be reorganized without listing on the stock exchange, including through the formation of a limited liability corporation with a single (state) owner. Reformers

³⁹ The legal framework provided by the Company Law was in place in 1994, but until 2003, only 30.4% of the *yangqi* had been reorganized. By the end of 2011, the share had increased to 72% (Wang 2012). Naughton (2015, 54) summarized the situation as follows: “eighteen years after the adoption of the Company Law, a quarter of SASAC’s firms have still not been converted. Even this overstates progress because, after all, the top-level firms are the largest and most important firms, and less than half of these have been converted into corporations under the Company Law. Most of the top-level firms are traditional state-owned enterprises with ‘managerial responsibility systems’ (SASAC Yearbook 2009, 57–58; Wang 2012).”

saw corporatization as key to both of their main policy objectives. As a fundamental reform of corporate governance, corporatization permitted much greater clarity in the relations between owner and manager, giving managers a more delineated scope of authority, while also allowing the creation of better types of incentive payment. At the same time, the corporation would provide greater flexibility in restructuring, since it provided new avenues to merge firms, spin off peripheral companies and assets, and raise funds through listing on stock markets.

In contemporary China, the three terms for SOE (*guoyou qiye*), corporation/company (*gongsi*), and modern enterprise system (*xiandai qiye zhidu*) are used interchangeably. Legally, SOEs should be restricted to state-owned enterprises regulated in accord with the Enterprise Law.⁴⁰ Corporations or companies are shareholding companies regulated by the Company Law.⁴¹ The reformers' corporatization agenda pursues the conversion of enterprises to companies, but the two different types of legal entities still coexist. The third term, modern enterprise system (MES), despite its use of "enterprise," connotes state-owned companies regulated by the Company Law. The basic features of the MES are "clear property rights, clear-cut authority and responsibility, separation of politics and enterprises, and scientific management" (SPC 1996, 158). The Ninth Five-Year Plan set the goals of the MES as follows:

⁴⁰ Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People (Enterprise Law), effective as of August 1, 1988 (<http://en.pkulaw.cn/display.aspx?cgid=3789&lib=law>)

⁴¹ Company Law of the People's Republic of China (Company Law), effective as of July 1, 1994 (<http://www.lawinfochina.com/Display.aspx?lib=law&ID=641>) and 2013 Amendment, effective as of January 1, 2006 (<http://en.pkulaw.cn/display.aspx?cgid=218774&lib=law>)

The MES is for adapting to the demands of socialized mass production and the development of the market economy. The MES is a new type of enterprise institution, which is based on renovation of business enterprise incorporation. The distinctive features of the MES are limited liability, scientific leadership structure, and organizational institutions, and its prevailing morphological manifestation is the *gongsizhi* company. (SPC 1996, 158; my translation)

By allowing shareholders to be the owners of companies, the Company Law clarified the relation between owner and company.⁴² When all enterprise was owned by the whole people, all enterprises were parts of the state at some level according to administrative “subordinate relations” (*lishu guanxi*). However, in the modern enterprise system, which is regulated by the Company Law, the financial relationship created through holding stock shares has replaced the administrative ties of state-business relations. The new financial ties also facilitated the formation of multilevel business groups, as encouraged by the “large corporations, large business groups” reform.⁴³ With corporatization, specifying “who owns what” became an urgent issue. Financial ties mediated by stock sharing facilitated a hierarchical restructuring between SASAC, the group headquarters of the *yangqis*, and their subsidiaries.

At the business-group level, corporatization led to the formation of multilevel corporation systems, as shown in Figure 4-2. Under this system, both the parent company and the

⁴² About the ownership of enterprises and companies, compare the following two articles in the Enterprise Law and the Company Law: “The property of the enterprise *shall be owned by the whole people*, and shall be operated and managed by the enterprise with the authorization of the state in line with the principle of the separation of ownership and managerial authority. The enterprise shall enjoy the rights to possess, utilize and dispose of, according to law, the property which the state has authorized it to operate and manage (Article 2, Chapter 1 of the Enterprise Law, my emphasis); “The *shareholders of a company* shall be entitled to enjoy the capital proceeds, participate in making important decisions, choose managers and enjoy other rights” (Article 4, Chapter 1 of the Company Law, my emphasis).

⁴³ On the pro-big business strategy, see Eaton 2015 and Li 2015.

subsidiary companies are independent legal entities, which are registered separately in the industrial and commercial administrative bureaus (Jia, Wen, Han, and Liu 2007, 3). The state has allowed the corporatization of whole business groups to happen only very gradually, in part because of the potential for it to lead to massive labor lay-offs, which, without a state-sponsored social security system, might threaten social stability (Naughton 2015, 54–57).⁴⁴ In most cases, corporatization though listing on the stock exchange was allowed only for a few of the most profitable subsidiary companies operating entirely within their industries' main business area. Subsidiaries operating in low-profit service sectors or that had a large number of workers undermined the value of their listed parent companies, and so were transferred to other, unlisted companies. One or more of the reconstructed SOEs became the first-level subsidiaries and then merged under the guidance of administrative orders to establish “national teams” (*guojiadui*). The business group headquarters (*mugongsi* or mother company) were then placed over subsidiary companies (*zigongsi*) ex post facto. During the transition, the group headquarters had the highest position in the vertical structure, although they were set up to eventually function as intermediaries between SASAC and subsidiary companies. Even after this restructuring of the business group, in many cases, the group headquarters are registered as enterprises (*qiye*) according to the Enterprise Law, and subsidiary companies, especially in their main business areas, are registered as company (*gongsi*) according to the Company Law.

⁴⁴ SOEs fulfilled many important social welfare functions during the state planning system period (*qiye ban shehui*), and in many cases they provided a considerable amount of local taxes and employment (Steinfeld 1998).

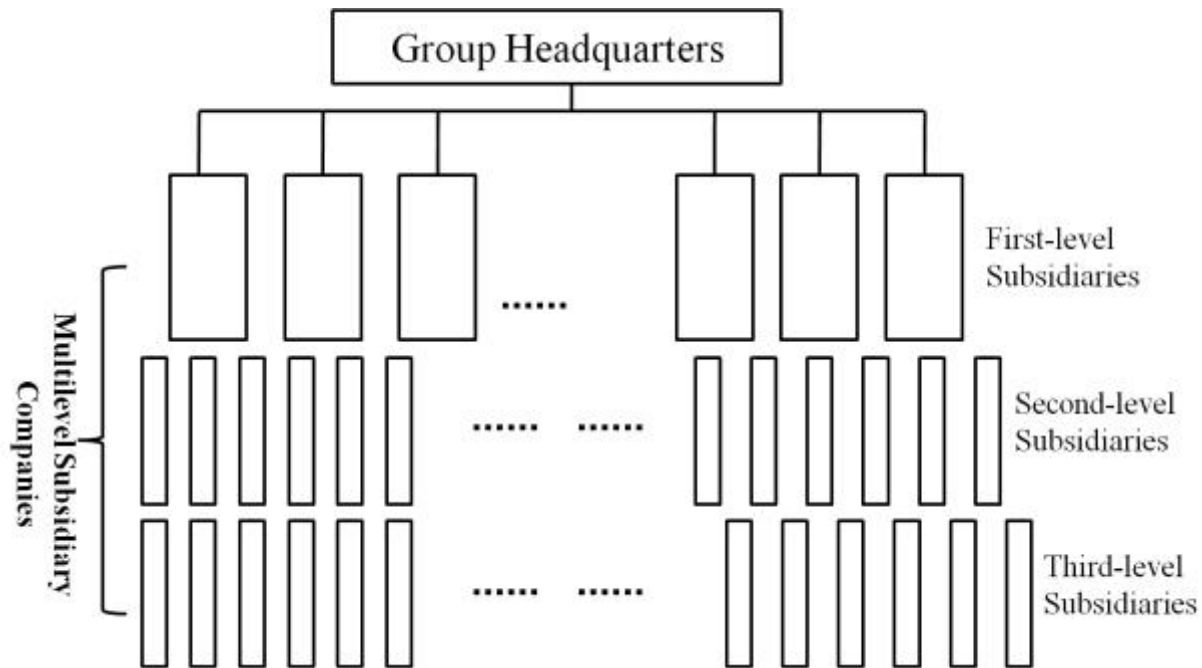


Figure 4-2. Multilevel corporation system of Chinese state-owned business group.

Source: Jia et al. (2007, 4).

Note: There is no solid line between the first-level subsidiary and below, because in the multilevel corporate system, there are very complex cross-shareholding phenomena, rather than a straight-line relationship. For example, a second-tier company's shareholders can be diversified, possibly including the parent company, one or more first-level subsidiaries, and external investors.

The group headquarters were intentionally created to be intermediary agencies between SASAC and subsidiary companies. Although group headquarters' ownership relations with the subsidiary companies are diverse, including wholly owned, majority holding, or equity participating, the group headquarters are solely owned by SASAC. The strategy of forming large business groups provided the party-state a convenient tool for controlling the business groups indirectly. As the single owner of the group headquarters, SASAC has the right to appoint top executives, dispatch independent board members, and conduct audits. The clarification of the ownership structure also freed SASAC from unlimited liability for state-owned business groups. However, SASAC does not have a legal rationale to intervene in subsidiary-level firms, creating the need for an agency that has the legal right to do so. A Chinese scholar, Yang Yungao (2008),

described the parent company as a corporate Politburo (*gongsi zhengzhiju*). Sutherland and Ning (2015, 140) evaluated this pyramid group formation strategy as a “desirable option for those accustomed to holding power.”

At the central state and *yangqi* level, the establishment of SASAC bestowed much more autonomy than before by clarifying responsibilities as follows. First, SASAC clarified ownership in the central and local vertical structure. Because the “central SASAC has no direct hierarchical authority over local SASACs” as Naughton (2006, 17) noted, the local states were able to manage their assets more independently. Second, SASAC also clarified responsibilities among horizontal central ministries. Finally, SASAC separated the institutions responsible for macroeconomic policy (NDRC) from those with ownership (SASAC) (Chen 2005). But above all, financial ties between SASAC and central SOEs further strengthened financial incentives. A vital consideration in the eyes of SASAC is how to increase, or at least preserve, the value of state-owned assets. SASAC has been revising its evaluation criteria for top SOE managers, but, still, “profit taking typically [takes] on a weight between one-third and two-thirds of the total” in the evaluation criteria (Naughton 2015, 56). This financialized incentive structure has had profound effects on the SOEs’ operation.

4.5 Implications for Auto Industrial Policy Implementation

After the Zhu Rongji period’s SOE restructuring, only two business groups in the automotive sector, FAW and Dongfeng, were restructured into SASAC-controlled *yangqis*. The changes in state-business relations have had different impacts on auto industrial policy implementation for these two *yangqis* and the other enterprises in the industry.

4.5.1 Opening Up Chances for Non-State Enterprises by Selective Retreat

The overall situation of SOEs in the auto industry during the late 1990s was fairly similar to that of other SOEs. As shown in Table 4-4, in 1998, 66 out of 115 auto manufacturers were state-owned, and 37 of these (56% of all SOEs) were in the red. Even though SOEs produced more than 40% of the total output value, they were losing money. Only limited liability companies and JVs were operating in the black, with the JVs reaping more than 90% of total profits. After the period of 1997–1999, which was dubbed “the three years of getting away from difficulty” (*sannian tuokun*),⁴⁵ the total number of auto manufacturer SOEs and the deficit companies among them decreased dramatically. Between 1998 and 2002, 30 SOEs had transformed ownership types, and the remaining SOEs’ total profit value went up; the number of deficit SOEs decreased from 37 to 13. Based on these numbers, it is logical to infer that the majority of the transformed SOEs had been in deficit in 1998. Thus, the original intentions of “grasp the large, let go of the small” were realized in the auto industry.

⁴⁵ The first plenary session of the 15th CCP Congress held in autumn of 1997 urged the government to “extricate [itself from] the majority of state-owned loss-making enterprises, and strive to establish a modern enterprise system in the majority of large and medium SOEs within three years.” This is the origin of the phrase “the three years of getting away from difficulty” (Zhang and Yuan 2008, 119).

Table 4-4. Total Number of Automobile Companies, Number of Deficit Companies, and Percentage of Total Output Value and Profit by Ownership Types, 1998, 2002, 2005, and 2011

| | Total | State | Collective | Cooperatives | Joint Ownership | Limited-Liability | Shareholding | Private | HMT JV | JV |
|------------------------|-------|--------|------------|--------------|-----------------|-------------------|--------------|---------|--------|-------|
| 1998 | | | | | | | | | | |
| Total # of companies | 115 | 66 | 2 | 2 | 1 | 20 | 4 | 0 | 6 | 14 |
| # of deficit companies | 59 | 37 | 2 | 1 | 1 | 7 | 2 | 0 | 2 | 7 |
| Total output value (%) | | 43.49 | 0.06 | 0.21 | 0.11 | 22.18 | 0.38 | 0 | 1.45 | 32.17 |
| Total profit (%) | | -16.64 | -1.21 | -0.29 | -0.52 | 31.31 | -2.1 | 0 | -1.52 | 90.99 |
| 2002 | | | | | | | | | | |
| Total # of companies | 117 | 36 | 0 | 2 | 0 | 37 | 14 | 0 | 6 | 22 |
| # of deficit companies | 31 | 13 | 0 | 0 | 0 | 7 | 2 | 0 | 2 | 7 |
| | 26.49 | 36.1 | 0 | 0 | 0 | 18.91 | 14.28 | 0 | 33.3 | 31.81 |
| Total output value (%) | | 47.23 | 0 | 0.21 | 0 | 21.48 | 5.57 | 0 | 3.1 | 22.32 |
| Total profit (%) | | 43.43 | 0 | 0.1 | 0 | 13.22 | -2.05 | 0 | 2.19 | 43.08 |
| 2005 | | | | | | | | | | |
| Total # of companies | 117 | 34 | 0 | 1 | 0 | 41 | 10 | 1 | 4 | 26 |
| # of deficit companies | 35 | 14 | 0 | 0 | 0 | 14 | 2 | 1 | 1 | 3 |
| | 29.91 | 41.17 | 0 | 0 | 0 | 34.14 | 20 | 100 | 25 | 11.53 |
| Total output value (%) | | 27.49 | 0 | 0.1 | 0 | 22.31 | 12.43 | 0 | 1.31 | 36.33 |
| Total profit (%) | | 13.72 | 0 | 0.05 | 0 | 9.64 | 1.4 | -0.02 | 0.39 | 74.91 |
| 2011 | | | | | | | | | | |
| Total # of companies | 115 | 12 | 1 | 1 | 1 | 28 | 17 | 8 | 4 | 43 |
| # of deficit companies | 18 | 2 | 1 | 1 | 1 | 8 | 0 | 2 | 0 | 3 |
| | 15.65 | 16.6 | 100 | 100 | 100 | 28.57 | 0 | 25 | 0 | 6.9 |
| Total output value (%) | | 29.62 | 0.34 | 0.59 | 0.89 | 16.71 | 11.17 | 2.94 | 0.9 | 36.79 |
| Total profit (%) | | 30.14 | 0.11 | 0.23 | 0.34 | 17.73 | 12.06 | 2.95 | 0.89 | 36.51 |

Source: Compiled by author from *China Automotive Industry Yearbook*, multiple years.

Note: Ownership types: (1) **Domestic-funded corporations: state-owned** (*guoyou*), **collective-owned** (*jiti*), shareholding **cooperatives** (*gufen hezuo*), **joint ownership** (*lianying*), **limited liability** corporations (*youxian zeren gongsi*), **shareholding** corporations (*gufen youxian gongsi*), **private** (*siying*); (2) **HMT JV**: corporations with funds from Hong Kong, Macao, and Taiwan (*Gang Ao Taishanng touzi gongsi*); (3) **JV**: foreign funded enterprises (*waishang touzi qiye*).

However, it is a serious misunderstanding to equate ownership transformation with privatization (Guo 2003, 566–567). The most increased ownership types are limited liability companies (*youxian zeren gongsi*) and shareholding companies (*gufen youxian gongsi*). The former type increased from 20 to 37 between 1998 and 2002. The number of the latter rose from

4 to 14 during the same period. The creation of limited liability corporations was the dominant method used for the large SOEs, with listed stock, mergers, and acquisitions among state shareholders. The formation of shareholding companies was the preferred method for small SOEs. Making them into shareholding cooperatives (*gufen hezuo*) entailed selling small SOEs to all employees through full implementation of employee ownership. By purchasing stock, the workers became the shareholders. This type of ownership transformation was much easier to implement than other types because the “joint stock system” (*gufenzhi*), in which workers became the owners of the company, was believed to accord with socialism (Zhang and Yuan 2008, 87).

The transformation of small and medium SOEs, along with the decrease in the central government’s supervision capability caused by the organizational reforms (chapter 3), together created a rare opportunity for nontraditional actors to enter the auto manufacturing industry. Owing to the industry’s high profits and high developmental potential (Lu and Feng 2004), many nontraditional players were eager to join and ride the wave of what became a car manufacturing “fever” or “movement” (Rensheng Yang 2004). The performance record of private companies is available only from 2005 (Table 4-4), but private or subprovincial local governments’ journeys to secure vehicle production permits, preferably sedan production licenses, had already started around the mid-1990s, in the middle of *zhuada fangxiao*. This was the case for Geely, which introduced its first sedan model in 1998 under a bus production license, as it did not receive a sedan production license until 2001 (Li 2014).

In 2003, BYD, a private company that was a frontrunner in the battery industry, purchased 77% of the stock of Xian Qinchuan Auto Limited Liability Companies and entered the sedan production industry. BYD’s successful entry into the sedan industry is a typical example

of how the SOE ownership reform distorted AIP implementation, especially entry control. Xian Qinchuan Auto was affiliated with the China Weapon Industry Corporation. As explained in section 4.3, the 1999 CCP decision on SOE reform specified four priority realms for public ownership control. These four realms became the primary targets of the “grasp the large” strategy. In July 1999, five defense corporations transformed into 10 defense business groups. These 10 large business groups became the backbone of the central SOEs (Zhu 2011, 277–281). In 2003, Xian Qinchuan Auto was a residue of the process of grasping the large. Furthermore, it was January when BYD bought in, and the new agency responsible for industrial policy, NDRC, was not established until March of that year. Auto production licenses were not eligible for transfer, but the absence of administrative power allowed the emergence of new actors in the auto industry.

4.5.2 Distorted Incentive Structures of State-Led Corporatization and Financialization

State-led corporatization and financialization contributed to the creation of the vertical hierarchy that put SASAC above the central SOEs. This hierarchical structure has led central SOEs to pursue financial interests rather than implement the goals of the auto industrial policy. According to the 2012 National Audit Office Report on the FAW:

Between 2008 and 2010, the proportion of independent research and development investment was low; the profitability of independent brand cars was not strong; and the FAW Group’s profits [came] mainly from the joint venture subsidiaries.
(National Audit Office 2012; my translation)

Rather than fulfilling the goals of industrial policies, the largest beneficiary of the AIP, FAW, became parts suppliers for the JVs. Its independent brand sedan Benteng's annual sales performance also has been poor, remaining below 50,000 units per year (Yuan 2012).

The distorted incentive structure is mainly caused by the long chains of “principal-agent” relations from SASAC at the top, to business group headquarters in the middle, and to the subsidiary companies at the bottom. To strengthen control over their agents, SASAC and group headquarters sought various control measures. First, SASAC promoted a “board of directors” experiment at central-level SOEs (Yeo 2013). A board of directors is a requirement for a corporatized company, but many companies had not established a board even after the conversion. The FAW Car Co., Ltd. (stock code: 000800), a listed FAW first-level subsidiary company, established its official board of directors in 2013. Among seven board members, three were FAW Group employees (including one manager and one party committee secretary) and four were independent (*People's Daily* 2013, April 18). Those four external board members were directly dispatched by SASAC. Second, SASAC also regularly sends auditors to central SOEs. Finally, as the ultimate owner of the central SOEs, SASAC appoints the top management with the cooperation of the State Council and the Party's Department of Organization. A survey of nine central SOEs, conducted between the period of December 2005 and July 2006, showed that a third of the top managers were appointed by SASAC alone, and another third were appointed by SASAC in cooperation with the CCP Department of Organization. Because of the enormous influence of SASAC through its control of personnel, the top managers of central SOEs have to pay attention to SASAC's evaluation criteria.

Table 4-5. Top Managers' Appointments in Nine Central SOEs, 2006

| | Number of Surveyed SOEs | Agencies Responsible for Top Managers' Appointment | | | | |
|------------|-------------------------|--|---------------------------------------|-----------------------|-------------------------------|--------|
| | | State Council | State Council & Dept. of Organization | Dept. of Organization | SASAC & Dept. of Organization | SASAC |
| Number | 9 | 1 | 1 | 1 | 3 | 3 |
| Percentage | 100% | 11.11% | 11.11% | 11.11% | 33.33% | 33.33% |

Source: Jia et al. (2007, 13).

The First Auto Works (FAW) group, as of 2005, comprised one parent company, 30 wholly owned subsidiary companies, 17 holding subsidiary companies, and 28 equity participating companies. Facing 75 subsidiary companies, the group headquarters shares the worries of SASAC. In regard to corporate governance, its primary concern is how to make the subsidiary companies follow the group headquarters' intentions. The working mechanisms within the group hierarchy are fairly similar to the relationship between SASAC and the parent company. In August 2004, SASAC organized a meeting for central SOE executives to share their experiences in connection to some of the important topics of SOE reform. Based on this conference, SASAC published a collection of exemplary cases of central SOEs in a book entitled *Exploration and Practice for Being Strong and Large* (2005). The FAW group contributed a section about parent-subsidary company management, which emphasized the different roles of group headquarters and subsidiary companies: the former is in charge of planning, while the latter is in charge of operations. In order to function as a single business group, linking these two different systems is a critical task.

The FAW's contribution suggested three different measures to tightly connect the two separate systems. First, the parent company should control personnel affairs at the subsidiary companies by placing managers in concurrent positions at the parent and subsidiary companies. The chairs of the boards of directors at subsidiary companies are usually held by the general

manager or vice general manager of the parent company. The other board members are also high-ranking managers at the parent companies. Second, the parent company should run the auditing system, sending auditors (who are high-ranking members of the parent company as well) directly to their wholly owned subsidiary companies. Finally, the parent company should lead and oversee all decision-making processes, providing agendas in advance. Because the ownership structures of subsidiary companies are diversified, the parent company must employ different measures to control agenda-setting. In the case of listed or joint venture subsidiary companies, little room for intervention may remain, as the management is much more institutionalized and standardized by company law or JV contracts. But for nonlisted, wholly owned subsidiary companies, the parent company, as the sole shareholder, can devise more complicated ways to control decision-making processes. As the term “inside first, outside later” indicates, because the parent company is not directly involved in operations, the subsidiary companies (inside) can initiate discussion on important matters. But at the same time, the subsidiary companies must consult the board members, who are dispatched from the parent company, and report to their functional division of the parent company. Once the functional division at the headquarters accepts a report from the subsidiary company, a review at the parent company (outside) must be completed before a final decision is taken by the subsidiary company. The functional division transfers the matter to the related committees and the general managers’ business meeting. A matter can be put on the agenda of a board of directors’ meeting at the subsidiary company only after getting permission to do so from the parent company (SASAC 2005).

To further ensure that subsidiary companies’ board meeting decisions accord with the intentions of the parent company, the sequence of board meetings is also set up in advance. The

main agenda of board meetings held in the spring must be about planning and implementation, and the meetings at subsidiary companies must follow those at the parent company. Fall board meetings' agenda must be about budgets, and the meetings at the subsidiary companies must be held after the group's annual investment meeting. In this way, the group headquarters can give regular guidance to its subsidiary companies.

4.6 Conclusion

This chapter has traced the changes in state-business relations, and their impacts on AIP implementation, after the Zhu Rongji period's "grasp the large, let go of the small" strategy. Contrary to the claims of "plan to market transition" proponents, Chinese reformers postulated a superstructure and a substructure, with different mechanisms and goals, by referring to Marxist theory. The superstructure should run by the command of the party-state; hence, it is not much different from a traditional planning system. In contrast, the substructure was intended to maximize productive capacity by incorporating market mechanisms. While the super and substructures are run by different mechanisms, the party-state devised institutional tools to mediate between the two systems.

The dualistic approach to overall SOE reform applied to the individual industries, including the auto industry, as well. At the industry level, the point of "grasp the large, let go of the small" was to select the important enterprises and consolidate them under the new state-owned assets management system. The selected firms became part of the superstructure that was directly under the party-state's political control. At the same time, the reform opened rare opportunities for new actors to enter the auto industry. The medium and small SOEs that were dropped from direct state-ownership were assigned new missions as the substructure. Despite

continued implementation of strict entry control, the Chinese central government granted new actors legitimate qualifications to operate as far as they were able to help increase the total productive forces as rapidly as possible.

At the business-group level, within those grasped by the newly established SASAC, the strategy of “large corporations, large business groups” (*dagongsi, dajituan*) reformulated central SOEs to run in a “multilevel corporate body management system.” The parent company (superstructure) is solely owned by SASAC, but the ownership types at subsidiary companies (substructure) are diversified among wholly owned, majority holding, or equity participating. The Chinese-style vertical integration of planning and market mechanisms did not transform ailing SOEs into efficient ones. But this vertical integration allowed the state to maintain a firm grip on important economic sectors. The Chinese party-state’s continued intervention through vertical integration is not enough to enhance economic efficiency, because of the long chains of “principal-agent” relations and the large potential for rent-seeking activities and short-term profit-seeking by high-level cadre-entrepreneurs due to frequent personnel rotation. Despite these shortcomings, the continuing intervention of the state through vertically embedded market mechanisms within the state planning system expanded, rather than hampered, market functions in overall resource allocation. In a transitional economy like China’s, where market mechanisms and market actors did not originally exist, more consistent rule-making functions that eventually supported market operations were urgently needed. Therefore, counter to the predictions that an economy in transition must follow a “plan to market narrative” or “transition orthodoxy,” market mechanisms in China did not arise from the complete extinction of the state planning system, but alongside it as the party-state remolded its shape and functions.

CHAPTER 5

Central-Local Fiscal Restructuring and the Rise of the Local Corporate State

5.1 Introduction

The Chinese central government initiated fiscal reforms to enhance central fiscal capacities as part of its efforts to build the socialist market economy from 1994 onwards. In 1994, a tax-sharing system (*fenshuizhi*; TSS) replaced the previous tax-contracting system, and this fiscal reform changed local governments' incentive structures and, subsequently, the local development model. Although secure property rights are traditionally considered to be a necessary condition for high economic growth (North and Weingast 1989), institutional settings in early reform China were not versed in protecting property rights at the individual level. The fiscal contracting system before 1994 instead promoted a merged state and economy, with local government officials "acting as the equivalent of a board of directors" (Oi 1992, 100). Fiscal contracting, according to Oi, "assigned local governments property rights over increased income and ... created local officials to pursue local economic development" (100). Under the fiscal contracting system, local government was allowed to retain tax surpluses beyond a contracted "baseline amount" regardless of the tax category. Therefore, the local government had a strong incentive to own and farm cash cows to fill its coffers. In contrast, under the TSS, taxes are assigned to central government or local governments, and shared differently according to their category. (See Table 5-2.) Under the previous system, what was important was not what was taken out, but what was left. The tax surplus had mattered a great deal to local governments. But under the new fiscal system, a development strategy that could selectively increase only local taxes became a much more reasonable approach for local officials.

This chapter argues that fiscal reform after 1993, when the socialist market economy was initiated, changed the roles and incentives of local governments and that these changes subsequently affected the coalition politics of auto industrial policy by shifting the relations of local governments and SOEs.⁴⁶ Fiscal reform along with banking reform increased the costs of directly owing collective or state-owned enterprises especially at subprovincial levels. Hence, local governments actively compete with each other to attract more businesses that can create more taxes and employment. Before 1993, Chinese society was composed of like units such as *danwei* at different levels; hence, the functional division of labor was inchoate.⁴⁷ Even central and provincial governments' major roles were quite similar. However, the 1994 fiscal centralization reform and bank reform, which severed banks from provincial governments, changed local government incentives and their roles in industrial governance. Because every province had the same incentives, the new type of local state, that is, the "local corporate state," replaced the previous "local state corporatism" (Oi 1992). The rise of the "local corporate state" proceeded in tandem with the central government's efforts to consolidate the large central SOEs. These conflicting movements led to the formation of two major coalitions in the auto industry, which subsequently further constrained effective implementation of auto industrial policy.

In the next section (5.2), I analyze how the 1994 fiscal reform shifted the cost structure of SOE ownership. Local reactions to the changed cost structure differed, so I then examine varying arrangements of local government-business relations with three case studies (section 5.3). Section 5.4 of this chapter explores the formation of coalitions in the auto industry and its impact on auto industrial policy implementation, and section 5.5 concludes the chapter.

⁴⁶ Banking reform also contributed to loosening relations between local governments and SOEs. See Yang 2004.

⁴⁷ Vivienne Shue (1988) called the structural pattern of Chinese cell-like communities and bureaucratic units as "honeycomb" model. Like a cell in honeycomb, *danwei* had been a self-sufficient unit. For the historical and comparative analysis on *danwei*, see Lu and Perry eds. 1997.

5.2 Fiscal Reform and the Changing Cost Structure of SOEs

Tax-sharing reform and industrial policy were both launched to accomplish the goals of the socialist market economy around 1994. The former was mainly introduced to remedy the “two ratios” problem. The previous fiscal contracting system, which was launched in the mid-1980s and further developed in 1988, was successful in motivating local economic development, but seriously weakened the central government’s fiscal capacity. “Two ratios” refers to the ratios of (1) fiscal revenue to GDP and (2) central fiscal revenue to total fiscal revenue. The first ratio was 28.4% in 1979, but it decreased to 12.6% in 1993. The second ratio also declined dramatically, from 46.8% to 31.6%, in the same period (Wang 1997). The fall in the two ratios severely damaged the central state’s fiscal capabilities and led to fiscal reform. (See Figure 5-1.) On the other hand, one of the major intentions of promoting industrial policy was to make it a substitute for economic planning. Socialist planning had proved to be obsolete and insufficient to bring the expected level of economic growth, and therefore the agreement to dismantle the old planning system was reached easily. But Chinese leaders never intended to lose policy tools that allowed them to lead the trends of economic development or to intervene in the economy whenever they thought it necessary. Whereas the fiscal reform was intended to strengthen central fiscal capacity, the industrial policy was designed to let the central government keep hold of the reins of the economy.⁴⁸ The change in the former, however, transformed local governments’ incentives and the policy tools they could use. These changes consequently changed local governments’

⁴⁸ In 1987, the Development Research Center of the State Council in China published a research article about industrial policy that was widely circulated among Chinese policy makers. The article defined the primary function of industrial policy as follows: “At this stage, [industrial policy] has the function of filling the vacuum of the planned economy and promoting the market economy, and it needs to become a useful tool for transitioning towards a planned commodity economy” (Li, Zhou, Liu and Lin 1999 [1987], 8; my translation). When the fierce debate about market and planned economies reached a deadlock, Chinese policy makers expected the roles of industrial policy to offer an intermediate mechanism to smooth the transition.

economic behaviors as well as the relations between local states and SOEs. The local development model under the new fiscal arrangements eventually came into conflict with central industrial policy.

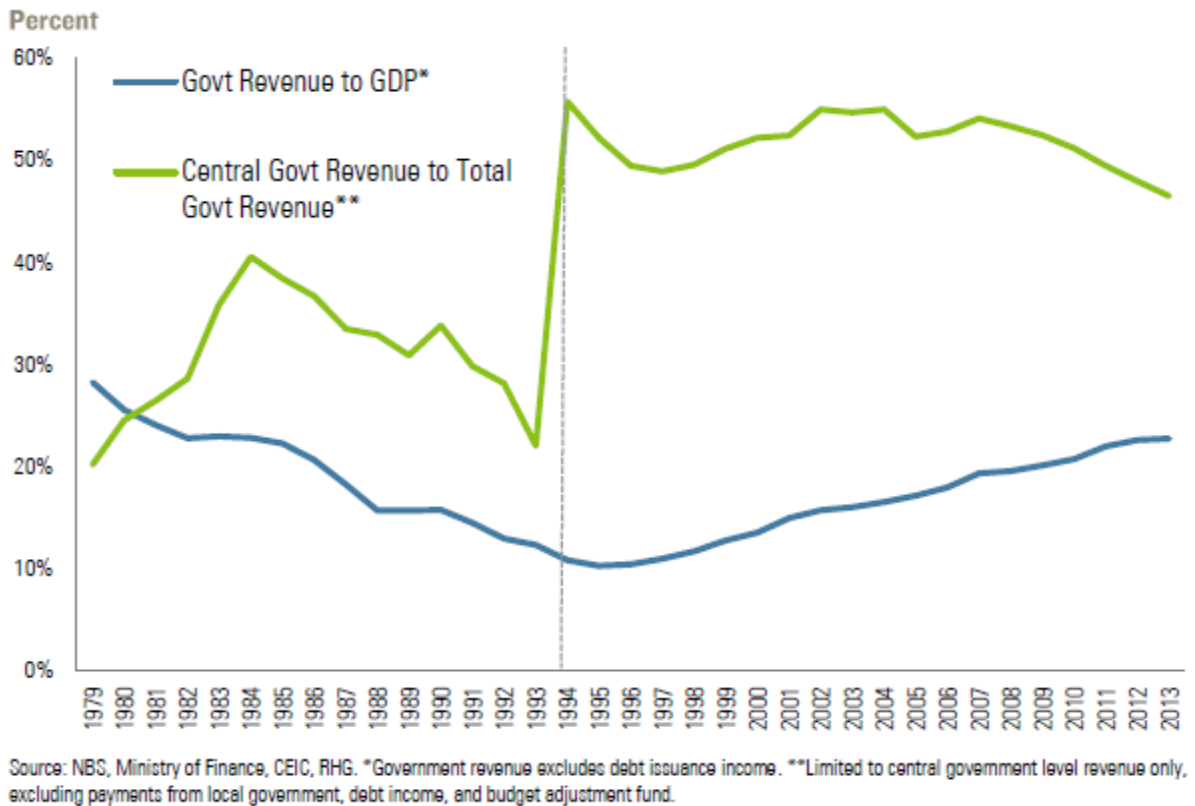


Figure 5-1. Changes of the “two ratios” before and after the 1994 tax-sharing system.
 Source: <http://rhg.com/notes/chinas-fiscal-and-tax-reforms-a-critical-move-on-the-chessboard>

After the 1994 fiscal reform, a saying that can be translated as “Do not pursue ownership of the firm, but seek to locate the firm within your boundaries and further strive for development” was widely circulated among Chinese local officials (Zhang and Yuan 2008, 176). Table 5-1 shows the changing sources of local taxes before and after the 1994 tax-sharing reform. First, commodity turnover taxes (production tax and value added tax) were abolished or reduced in importance. The production tax (*chanpinshui*) was completely removed in 1994. While the contribution of value added tax (VAT) to local taxes peaked in 1994, it then continuously

decreased, from 23.28% in 1991 to 15.89% in 2010. The decline of the commodity turnover taxes in local tax revenues undermined motivation for “pursuing ownership of the firm.” Even though business tax (*yingyeshui*) has been one of the largest sources of local tax revenues, it was not an amenable target for local governments before the 1994 TSS reform. Business tax is mainly “levied on the construction industry and tertiary industry, with the former the greatest contributor,” but local governments did not have the mandate to expand construction at that time, and the level of industrialization was simply not great enough to create flourishing tertiary industries (Sun and Zhou 2014, 55). As a result, commodity turnover taxes were considered to be a more viable target to increase local tax revenues. Whether or not a product is profitable, turnover taxes are levied once a firm has started production. For instance, VAT is levied on the added value between the input of materials and product output. The cost of final output is always higher than raw material, because wage costs and equipment depreciation must be added during the production process. Hence, in Sun and Zhou’s words, “the combination of a tax system based on turnover tax and a fiscal system with a fixed turnover base was a strong motivation for local governments to develop local enterprises, especially township and village enterprises” (52).

Table 5-1. Breakdown of Local Government Taxes in 1991, 1994, and 2010

| | 1991 | % | 1994 | % | 2010 | % |
|--|---------|--------|---------|--------|----------|--------|
| Production Tax | 473.13 | 21.41 | 0 | 0 | | 0 |
| VAT | 514.56 | 23.28 | 579.98 | 25.27 | 5196.27 | 15.89 |
| Company Income Tax | 272.24 | 12.32 | 291.51 | 12.70 | 5048.37 | 15.43 |
| Business Tax | 526.59 | 23.83 | 647.36 | 28.20 | 11004.57 | 33.65 |
| Tax on Resources | 18.80 | 0.85 | 45.45 | 1.98 | 417.57 | 1.27 |
| Personal Income Tax | | 0 | | 0 | 1973.30 | 6.03 |
| Urban Land Using Tax | 15.74 | 0.71 | 32.51 | 1.41 | 1004.01 | 3.07 |
| Stamp Tax on Security Exchanges | 10.16 | 0.45 | 22.66 | 0.98 | 16.34 | 0.04 |
| Other Industrial and Commercial Taxes | 156.22 | 7.06 | 226.02 | 9.84 | | 0 |
| Salt Tax | 8.37 | 0.37 | | 0 | | 0 |
| Agriculture Tax | 72.79 | 3.29 | 195.02 | 8.49 | | 0 |
| Urban Maintenance and Construction Tax | 97.83 | 4.42 | 174.63 | 7.60 | 1736.27 | 5.30 |
| Fixed Assets Investment Adjustment Tax | 30.86 | 1.39 | 43.30 | 1.88 | | 0 |
| Tax on the Use of Arable Land | 13.33 | 0.60 | 36.47 | 1.58 | 888.64 | 2.71 |
| Other Taxes | | 0 | | 0 | 5455.15 | 16.68 |
| Total | 2209.62 | 100.00 | 2294.91 | 100.00 | 32701.49 | 100.00 |

Note: Unit: 100 million RMB

Source: Compiled by author from *Finance Yearbook of China* (1992, 1995, 2011)

Company income tax was another factor that had motivated local governments to pursue owning firms before the fiscal reform. In 1991, for example, company income tax was the fourth largest source of local tax revenues. Because commodity turnover tax and company income tax (boxed in Table 5-1) flow towards the owner according to the “subordinate relation” (*lishu guanxi*), these taxes motivated local governments to nurture their own state-owned or collective firms. If we only count the contribution ratio of commodity turnover tax and company income tax, it had already reached more than 56% of local tax revenues in 1991. Because increasing revenue from business tax was still beyond local governments’ capacities, nurturing locally owned firms was a reasonable strategy to improve local budget conditions.

Another change that stands out after the 1994 TSS is the rise of business tax’s share of total local government taxes. Business tax contributed 23.83% of local revenue in 1991, and 33.65% in 2010. Except for production tax, which was abolished in 1994, the ranking of the

primary sources has been relatively stable. (Figure 5-2) But the importance of business tax became much greater after 1994. The gap between business tax and VAT was less than 1 percentage point in 1991, but continuously widened until it was 17.76 percentage points in 2010. After the TSS reform, commodity turnover taxes lost their previous position in local government revenues, with business tax filling the gap. This change resulted from the new incentives accompanying the fiscal reform. The essential feature of the 1994 tax-sharing reform is that it changed the ways tax revenues were shared between central and local governments by shifting from “a negotiated system of general revenue sharing to a mix of tax assignments and tax sharing” (Wong and Bird 2008, 434). Table 5-2 presents the categories of tax assignments between the central and provincial governments.

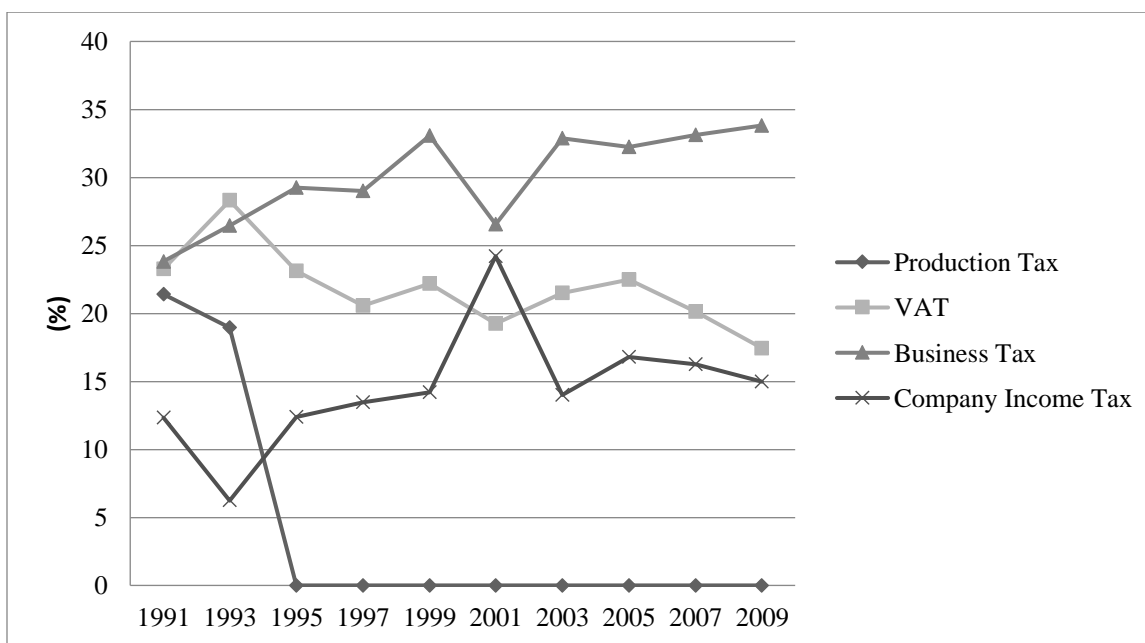


Figure 5-2. Four major sources of local government taxes, 1991–2009.
Source: Compiled by author from *Finance Yearbook of China*, numerous years.

Table 5-2. Revenue Assignments between the Central and Provincial Governments
(Source: World Bank [2002, Table 4.1], cited by Wong and Bird [2008, 435])

I. Taxes exclusively assigned to the central government

1. Excise taxes
2. Taxes collected from the Ministry of Railroads and from the headquarters of banks and insurance companies
3. Income taxes, sales taxes, and royalties from offshore oil activities of foreign companies and joint ventures
4. Energy and transportation fund contribution
5. Seventy percent of the three sales taxes collected from enterprise owned by the Ministry of Industry, the Ministry of Power, SINOPEC (petrochemicals), and the China nonferrous metal companies
6. All customs duty, VAT, and excise tax on imports
7. Enterprise income tax collected from banks and other financial institutions

II. Taxes shared between the central and local governments

1. Value-added tax (75% central and 25% provincial)
2. Natural resources taxes (coal, gas, and other minerals if the enterprises are fully Chinese owned)
3. Construction tax on the cost of construction of buildings that are outside the plan and financed from retained earnings
4. Salt tax
5. Industrial and commercial tax, and income tax levied on foreign and joint venture enterprises
6. Security and exchange tax (50% central and 50% provincial) – added in late 1990s
7. Income tax of all enterprises – added in 2002
8. Personal income taxes – added in 2002

III. Taxes exclusively assigned to local governments

1. Business (gross receipts) tax falling on sectors not covered by VAT (transportation and communications, construction, finance and insurance, post and telecommunications, culture and sports, entertainment, hotels and restaurants, and other)
2. Rural market (stall rental) trading tax
3. The urban maintenance and construction tax (a surcharge on the tax liability of enterprises for business tax, CT, and VAT)
4. The urban land-use tax
5. Vehicle and vessel utilization tax
6. Thirty percent of the product and VAT revenues collected from enterprises owned by the Ministry of Industry, Ministry of Power, SINOPEC, and the China nonferrous metal companies
7. Value-added tax on land
8. Education surtax
9. Entertainment and slaughter taxes
10. Property tax
11. Surtax on collective enterprises
12. Resources tax
13. Fixed-asset investment tax (discontinued in 1999)
14. Fines on delinquent taxes

VAT was assigned to the shared taxes, with 75% going to the central government and only 25% to the local. (II-1 in Table 5-2) While company income tax remained a local tax at the beginning of the TSS, it was also added to the shared taxes in 2002. (II-7 in Table 5-2) These changes further cooled local interest in owning enterprises. The loosened relations between local governments and SOEs had several implications for local development models. First, even after the TSS, the business tax was still solely a local tax; thus, local governments spontaneously changed their development strategies to garner more business tax. (III-1 in Table 5-2) Among industries, those that have large industrial linkages (Su, Tao, and Yang, forthcoming) or are related to land development (Sun and Zhou 2014) generate more business tax, and hence became preferable targets. Second, the loosened relationships also facilitated ownership transformation for local SOEs and Township and Village Enterprises (TVEs), as addressed in chapter 4. The relative ease of ownership transformation during the period of Zhu Rongji's administration mainly resulted from the changes of local governments' incentive structures caused by the TSS. Finally, the loosening relationships also opened up new chances for private enterprises. Local governments now started to pursue having any ownership-type businesses located within their boundaries, rather than trying to own the firms. If private firms can generate a good amount of local taxes and increase employment, local governments are willing to sponsor non-SOEs in their boundaries.

5.3 Rise of the Local Corporate State and Diverse Local Government-Business Relations

Institutional reforms accompanying the socialist market economy, including government organization reforms, SOE reforms, banking reforms, and fiscal reforms, led to complex interactions among multidirectional incentives. Overall, the reforms that followed the

inauguration of the socialist market economy aimed to maintain the central government's firm grip over the economy through industrial policy, centralize more fiscal power through the TSS in 1994, and strengthen central control over the large SOEs by establishing the SASAC in 2002. Because these reforms were oriented towards centralization, they differentiated the roles of central and local governments. The position of the local governments has never been equivalent to that of the central government, but in the previous fiscal contracting system their tasks were similar. Once a contract was established, and to the extent that a local government was able to fulfill its promises, most of the details of local administration were left to local leaders. The major differences between central and local administrations were ones of scale rather than responsibility. But after the TSS, clear divisions of labor between central and local governments emerged. In contrast to the pre-TSS "two ratios," the new fiscal system allocated the lion's share of tax revenues to the central government. The central government thus gained greater freedom from fiscal revenue concerns. In regard to SOEs, the central government began to step up its role as an asset owner by establishing the SASAC in 2003, and it now acts as controlling shareholder of about one hundred central state-owned mega-business groups and most of the commercial banks through Central Huijin Investment Ltd.⁴⁹

In contrast with the central government's strengthened control over large SOEs, local governments' situations vary according to their level. The situation of affluent provincial-level local governments, such as Shanghai, is similar to that of the central government. But most subprovincial governments face more fiscal constraints as well as disincentives to taking direct

⁴⁹ As mentioned in chapter 3, SASAC does not oversee banking sectors. Central Huijin takes that role in the banking and financial sectors, holding shares in 19 institutions as of December 31, 2015. For the information of its current shares, see:

http://www.huijin-inv.cn/wps/portal/lut/p/a1/pZHNDolwEISfxQcwuwIpeKyg_EjlQIjYC2mM_CRSiCEefHoL0SPFxLlt8k1mdhc45MCleDaVGJpOivs4c1KckODGTTFCRg9IHdyzxIyMJCmKuCjA9Wlg2TEiWo6BobcLPHvLEEOi9RPz48cZUdT5nfSbrwF-yp8BfMv8yz8CC_eLJkCzvwowHsxIFfBeDPW6kWUHed21t-Iq4Qxcl-AfjQVg3HACdC9c6rjOwYS-zZTyV1ymYRPS1RuhAyPa/dl5/d5/L2dBISEvZ0FBIS9nQSEh/

ownership of firms. Every local government faces the urgent need to farm tax bases, but their varying local conditions have made them choose different strategies. Under the fiscal contracting system before 1993, directly owing firms was the most lucrative way to increase fiscal revenue. But the TSS opened new possibilities for diverse relations between local governments and enterprises.

Zhao Shukai (2012), director general of the information center of the Development Research Center of the State Council, called this new type of local state the “corporate state,” in contrast to Jean Oi’s (1982) “local state corporatism.” Zhao identified three essential characteristics of the local corporate state: (1) a corporatized incentive structure, (2) a fragmented authority structure, and (3) a movement-type behavioral model. As a corporation, local government’s primary goal was to maximize fiscal revenue, so investment promotion became the most important task of the government. Local leaders frequently advertised their locales’ “low land prices,” “special taxes,” “low-interest loans,” and even “guaranteed acquisition of operation permits” (*zhunshengzheng*) (interview with a local government official, November 5, 2013, Tianjin). The behavior patterns of local corporate states, however, vary according to their administrative hierarchy and their local endowments. Hence, even though the TSS pushed local states to become “local corporate states,” each local state started by exploiting the resources it possessed. In the case of the auto industry, three changes in local state-business relations are especially apparent. In the fierce competition to “invite business and attract investments” (*zhaoshang yinzi*), the auto industry became an attractive target for local governments for multiple reasons. First, it has vast industrial linkages to other industries from primary to tertiary, as well as significant employment effects. Second, as a symbol of the manufacturing sector, the auto industry has a demonstration effect. Third, the auto industry

generates considerably more tax revenue than other manufacturing sectors. Finally, it is environmentally friendly, which has recently become an important criterion in cadre performance evaluation (interview with a high-ranking manager at an auto MNC in charge of negotiation with Chinese local governments, January 15, 2013, Beijing).

5.3.1 Growing leverage of private firms vis-à-vis local governments

The first change that emerged in local state-business relations after the TSS was the growing leverage of private actors over local governments. The changing relationships of Geely, a private auto company, with numerous local governments are typical in the rapid ascendancy of the private firm vis-à-vis the local states. When the first AIP was issued in 1994, the central government raised the entry barrier to the auto industry by controlling vehicle production licenses. The 1994 AIP intended to nurture a few large SOEs; at that time, it would have been unimaginable for Li Shufu, the founding father of Geely, to enter the auto manufacturing industry. Furthermore, because most of the vehicles produced were not bought by individuals but by institutions, private automakers had little chance of winning customers away from the incumbent SOEs. But when the new tide of “grasping the large, letting go the small” (*zhuada fangshao*) rolled in during Zhu Rongji’s administration, it opened a small space for new entrants in the protected auto industry. As mentioned earlier, the incentive to directly own firms has continuously decreased, especially for lower-level governments. Li Shufu’s long-cherished desire was realized when he was able to purchase a small bus production license by merging with a small auto company in Sichuan that was run by a local prison. But even access to the facility was not free owing to its location, and they were not allowed to produce sedans with this license.

Although Geely introduced its first sedan model, Haoqing, in February 1998, its sedan production license was officially awarded only in 2001 (Li 2014).

Less than a decade later acquiring legitimate status of sedan producer, Geely merged with Ford Motor's Swedish-origin Volvo sedan unit in 2010. The final bidding price was set around 1.5 billion USD, of which 1.1 billion (approximately 8.47 billion RMB in 2010) was financed by numerous local governments' investment in exchange for having plants established in their areas. The remaining 0.4 billion USD was funded by the London Branch of the Chinese Construction Bank and the selling party, Ford (0.2 billion USD each). The local governments involved in this project are subprovincial, largely at the prefectural or county level.⁵⁰ At the beginning, the county-level government of the Beijing Economic and Technological Development Area (BDA, *Beijing jingji jishu kaifaqu*) promised to invest 4–5 billion RMB, but the provincial-level SOE, BAIC, complained directly to the provincial-level Beijing municipal government, requesting its full support of BAIC's upcoming initial public offering and the cancellation of the county government's offer to Geely. The prefecture-level Daqing city government of Heilongjiang seized this opportunity and invested 3 billion RMB. The county-level Shanghai Jiading district government also financed 1 billion RMB. Finally, the prefecture-level Chengdu city government of Sichuan also invested 2 billion RMB (Cui 2010a, 2010b; Zhao 2010). These subprovincial governments offered their investments with the condition that auto manufacturing plants be established in their territories. As of 2015, after fierce haggling, Geely finally put its production plants in Daqing, Chengdu, and Shanghai and located its headquarters and R&D center in the Jiading district of Shanghai.

⁵⁰ The structural hierarchy of Chinese administrative divisions consists of (1) 33 province-level regions, (2) 333 prefecture-level regions, (3) 2,862 county-level regions, (4) 41,636 township-level regions, and (5) even more village-level regions.

5.3.2 Transforming manufacturing SOEs into investment companies

The second pattern of change that followed the TSS occurred in regions where local governments could not afford to financially support their local SOEs. Instead of trying to nurture the independent development of the SOEs, these governments tacitly transformed the auto manufacturers into investment companies. This pattern was typical at financially poor provincial-level SOEs, such as the Tianjin Automotive Industry Corporation Group (TAIC).⁵¹ Tianjin Xiali, a subsidiary of the TAIC, was well known as a manufacturer of small sedans during the late 1980s and early 1990s. The Xiali sedan, which was originally based on the Japanese Daihatsu car, was so famous it led to a popular saying, “Yellow Daihatsu in front of Tiananmen Square, red Xiali at the banks of Shanghai” (Wei 2007). When maintaining its own SOEs became too costly, the Tianjin municipal government moved to attract taxable firms, instead of directly supporting the manufacturing companies.

In 2002, the TAIC merged with the FAW, as central-level SOEs. Merger and acquisition (M&A) in the market economy usually combines two companies into one, but in China M&A between different companies added to the number of enterprises. In the case of the Tianjin-FAW M&A, Tianjin Xiali was listed on the Shenzhen Stock Market in 1997 and established a JV with Toyota in 2000. The FAW acquired a 50.98% share of Tianjin Xiali, and the TAIC became the second largest shareholder. The FAW succeeded to the management rights for Tianjin Xiali and automatically became a JV partner with Toyota. While the central government’s AIP promoted transregional merges between dispersed auto manufacturing SOEs in order to remedy the low level of centralization, the Tianjin-FAW M&A case demonstrated the AIP’s limited effect. If the AIP’s original intention had been fulfilled, the TAIC would have been kicked out from the auto industry. However, this merger through a stock transaction only changed the TAIC’s business

⁵¹ Beijing and Tianjin are both provincial-level (*shengji*) municipalities (*zhixiashi*).

activities, as it went from being a manufacturing corporation to an investment corporation. Even after the Tianjin-FAW merger, the TAIC group as a whole has continued to operate in the red. The main income of the TAIC has been coming from the dividends of the Tianjin-FAW-Toyota JV. While the TAIC is under the supervision of the Tianjin SASAC, the Tianjin municipal government has no intention of closing it down, for two main reasons. First of all, the TAIC and the FAW agreed to register the merged company within Tianjin, so Tianjin is entitled to collect taxes from the new company. In the case of crossprovincial M&As, where the firm is registered determines which government has the right to collect the local taxes. Similarly, when the Beijing municipal government relocated the polluting factories of Capital Steel (*Shougang*) to Hebei province, it maintained its registration in Beijing to maintain the right to collect taxes from the company (interview with a local government official, October 26, 2013, Tianjin). Second, the TAIC still holds the automobile production license for its subsidiary company under the name of TAIC Meiya, and it has a plant with a 50,000-unit production capacity. The TAIC has made a variety of attempts, so far without success, to lease its production license to private firms for independent production of an SUV model (interviews with current Tianjin municipal government officials who were working at the TAIC during the Tianjin-FAW M&A, October 26, 2013 and November 4, 2013, Tianjin). The Beijing Automotive Industry Corporation (BAIC) is also showing signs of losing interest in developing its own models and instead focusing on expanding its operations through JV projects and M&As.

5.3.3 Playing with the “shell resources”

The previous section described a pattern in which SOEs became investment companies but held onto the minimum capacity to produce cars. These were provincial-level SOEs, so their local

government owners had much more power to attract central SOEs, as in the Tianjin case, and JVs, as in the Beijing case. Many subprovincial auto SOEs, however, built just enough vehicles to maintain their production license, never approaching even a minimal economy of scale. Especially since 2000, a large number of investors have come to see the huge potential for growth of the domestic car market. Although they want to get into the passenger car industry, the state's strict entry control has led them to circumvent government regulations by acquiring companies that hold production licenses. In this context, subprovincial governments attempt to exploit the scarcity value of their auto production licenses, which have been called "shell resources" (*kezhiyuan*). It has been reported that Chang'an, Ford and the Hangzhou city government purchased the production license of Kunming Chahua Auto at the price of 450 million RMB (equivalent to 70 million USD) to build a JV plant for Chang'an-Ford-Mazda (*Zhongxinwang* 2012). The JV team announced that they would invest 4.9 billion RMB (760 million USD) to build the 250,000-unit capacity plant; the price for the license therefore was equivalent to almost 10% of the amount of the fixed asset investment. A person familiar with the "shell resource" trade commented:

If the deal is completed at that high price, then those who pay will be not only the enterprise, but the Hangzhou Municipal Government may also bear a substantial burden. ... Local governments think large vehicle plant projects, particularly joint ventures, are very important, because they have tremendous GDP and tax pulling effects. Hence, in addition to land and tax concessions, the local government directly helps companies with "lots of money" to solve the "shell resource" problem. (*Zhou* 2012; my translation)

In the Chahua Auto case, both prefectural governments, Hangzhou and Kunming, benefitted from the trade. Hangzhou now can host the JV plant, which will expand its local GDP, employment, and tax bases. The Kunming prefectural government had already made a great deal of money by selling the factory site; it raked in an additional 450 million RMB by selling the production license.

In another prefectural city, Zhenjiang, Jiangsu province, legal disputes erupted over the production license. In 2004, the Zhejiang Jinggong Group, a private company in the neighboring Zhejiang province, merged with the Zhenjiang Auto Manufacturing Company and established the Zhenjiang Jinggong Auto Company. In a situation where truck sales were poor, the new owner sought to resell its automobile production license in Chongqing and Erdos, Neimenggu province. In the meantime, the new company's continuing deficit and unsolved labor problems made the city government determined to recover the "shell resource." In this situation, the Jiangsu Tianyang Group approached Zhenjiang city, and they agreed to Tianyang's overall acquisition including all debts, assets, and employees at 20 million RMB. After the deal was closed, Tianyang found that the most important resource of the company, the automobile production license, had already been transferred to the Zhenjiang Jinggong Group. Tianyang filed a lawsuit against Jinggong to recover the production license with the following legal rationale: "The production license is a state asset, so it is not eligible for transfer or sale. But as far as the joint venture remains a state-owned holding company, the change of license will be effective" (*Fazhi Zhoumo*, May 25, 2012).

A media report about Zhenjiang SASAC's research materials for the legal case shows the Zhenjiang government's stance towards the issue. Their primary interest was to "find ways to

ensure that the car production license, a scarce resource, does not drain away to other localities” (Liu Binbin 2013). The legal dispute, however, was solved through bargaining rather than going to court. Facing the uncertain situation of perhaps not being able to obtain an auto production license, the Tianyang Group took a traditional strategy of “climbing” (*panshang*) to a higher authority. For the prefecture-level players, a player from the capital, Beijing, looks overwhelming. So Tianyang attracted the attention of BAIC, a Beijing province-level SOE, and arranged to matchmake with the Zhenjiang government. While the specific details have not been confirmed, BAIC and the Zhenjiang government signed a strategic cooperation agreement in Nanjing on August 7, 2013, and announced BAIC’s merger with Zhenjiang Auto and its plan to invest 15 billion RMB (Liu 2013).

5.4 Emerging Coalitions and Constraints on Auto Industrial Policy Implementation

One of the major goals of the auto industrial policy was to nurture a sizable number of big players who could compete in the world market. The initially designated candidates were exclusively large SOEs, and the barriers to market entry for other players were raised to protect them. As expected, the auto industrial policy was much more favorable to these SOEs than to others. Nonetheless, the large SOEs did not realize the expected goals such as developing their own models and becoming major exporters, but instead became more dependent on their foreign JV partners for technology and capital. In contrast, private actors were not initially allowed to enter the auto manufacturing industry, but once they obtained their production licenses, they became indigenous developers who are now exporting their own models and brands.

As Table 5-3 indicates, the different incentive structures caused by the multidirectional reforms that have taken place since China embarked on the socialist market economy created two

competing coalition structures. The dominant coalition consists of central-level SOEs (*yangqi*) and large provincial-level SOEs. They are backed up by the central government agencies in charge of industrial policy. Most of them have already established multiple JVs with global auto manufacturers. The challenging coalition is composed of subprovincial level SOEs and private enterprises. They are supported by the Ministry of Science and Technology, which emphasizes indigenous innovation. While few companies in this coalition have started to form JVs, their foreign partners tend to be much smaller and their patterns of cooperation are much more diverse.

Table 5-3. Formation of Competing Coalitions in the Auto Industry

| Competing Coalitions | Central Government Ministries | Character of Enterprise | JVs with MNCs |
|-----------------------|------------------------------------|--------------------------------------|---------------|
| Dominant Coalition | NDRC, MIIT | central-level SOEs (<i>yangqi</i>) | all |
| | | provincial-level SOEs | most |
| Challenging Coalition | Ministry of Science and Technology | prefectural-level SOEs | some |
| | | private | very few |

This chapter analyzes the impacts of the TSS fiscal reform on the relationship between local governments and businesses. Unlike the previous tax-contracting system, the tax-sharing system suppressed local governments' interest in directly owning firms, especially the lower-level governments. The effects of the 1994 tax-sharing reform on the relationships between governments and SOEs were not uniform but varied according to the level of government as well as the size of the SOE. At higher governmental levels and with larger SOEs, the relationship between the two was more likely to grow closer. By establishing the SASAC in 2002, the central government strengthened its role as an asset owner over the central-level SOEs. On the other hand, if the level of government was lower and the size of the SOE smaller, the government's interest in directly owning the firm tended to plunge. One provincial-level deputy director of an

economic operations department suggested that, by their nature, the central SOEs tended to have stronger political purposes than the local SOEs. Local governments are in charge of the economic operation of local SOEs, so local-level SOEs must care more about economic factors (interview, October 14, 2013, Tianjin).

The varying effects of fiscal reform on state-business relations rendered the logic of behavior and approaches to business operations quite distinct between the large, extant SOEs and the diverse ownership types employed by the new entrants. The tax-sharing system allowed the central government to secure the lion's share of fiscal revenue. The central government's strengthened fiscal capacity also reinforced the central government's control over the large central SOEs. The relative affluence of the central government freed it from the need to pursue immediate economic concerns and allowed it to seek more abstract goals, such as "building a national team." Under the auspices of central and provincial governments, extant large SOEs were able to expand into large business groups (*daxing qiye jituan*). In 2014, one hundred Chinese companies appeared on the Fortune Global 500 list (http://www.chinadaily.com.cn/business/2014-07/08/content_17673632.htm). Among those listed, Shanghai Automotive Industry Corporation (SAIC) (85), FAW (111), and Dongfeng (113) are all large central and provincial auto SOEs.⁵² The scaling up of these SOEs was made possible by actively promoting the mixed ownership system (*hunhe suoyouzhi*). However, large SOEs rarely merged with private enterprises (Department of Industrial Policy, NDRC 2008, 889–893). While topped by wholly owned business groups, ownership diversification was realized only at the subsidiary level through initial public offerings (IPOs), formation of JVs, M&As of small and medium SOEs, and so on. Through such diversification, the big three expanded their business areas to become nationwide, but owing to different motivations and goals, the large SOEs'

⁵² Numbers in parenthesis show each company's rank in the 2014 Fortune Global 500 list.

activity hardly overlapped with that of the new entrants. A research report by the NDRC also pointed out that SOEs still absolutely dominate the automobile industry, and the dominant coalition remains largely separate from the challenging coalition (889–893). As new entrants are never allowed to trespass in the large SOEs' areas, the new entrants have gone through endless trial and error to establish their own positions. And although they initially seemed hopelessly disadvantaged, the economic reforms that have followed the establishment of the socialist market economy have opened up new chances.

The major issue of contestation between these two coalitions has been to what extent the state can allow the operation of nonpublic actors in the pillar industries. The primary rationale for holding state ownership in the pillar industries is that a certain amount of economic and material capacity in the form of SOEs is the base structure that undergirds the socialist superstructure (Jiang 2006). But when state-owned auto companies degenerated into parts producers for their JV partners, fledgling domestic firms that held their own intellectual property rights were able to win much broader public support. The Ministry of Science and Technology (MST) is one of the foremost supporters of indigenous companies in the central government. In 2004, the MST commissioned research projects on scientific innovation policy, and the resulting reports strongly backed up indigenous makers' development model (Lu and Feng 2004; Mei and Feng 2005). In 2005, the MST also based the National Automobile Engineering Technology Research Center of Energy Saving and Environmental Protection at Chery Auto (Chu 2011, 1257). In addition to this support from a central ministry, two leading figures, He Guangyuan, a former minister of the Ministry of Machine Building, and Long Yongtu, a former chief representative for trade negotiations for accession to the WTO, have also carried on a proxy war on behalf of the alliances about the meaning of "indigenous brands" since 2005 (*China Business*

and Trade 2014). Such support from a central ministry and the media exposure of indigenous brands' success stories have empowered the challenging coalition.

The established coalition structure has started to exert influence over policy making processes. A new AIP was originally scheduled for release around 2014, and was on the agenda at the MIIT as a major task for that year. However, controversies over issues such as entry control, the 50% foreign ownership limit for joint ventures, new vehicle energy policies, and the cancellation of "import control" prevented reaching consensus (Zhang 2014). The conflicts in producing previous AIPs were between alliances centered on traditional SOEs and nontraditional businesses, but the battlefronts are much more complicated now. Abolishing entry control means completely opening the industry to any domestic player; thus, both coalitions will oppose it stubbornly. By securing a production license, the indigenous companies have already become large beneficiaries of government support. For example, the three forerunner companies in the challenging coalition, Geely, BYD, and Chery, have relied heavily on government subsidies. In the first half of 2012, governments granted 634 million RMB to Geely; that is 50.3% of its pre-tax profit or 62.2% of its after-tax profit. In 2011, BYD received 300 million RMB in government support, which accounted for 21.7% of its net profit (1.38 billion RMB). At Chery, the amount of the government subsidies grew to exceed net profits between 2007 and 2009. Chery's government subsidies grew from 280 million in 2007 to 470 million in 2008 and to 630 million in 2009, while its net profits decreased from 1.43 billion to 310 million, and then to 70 million in the same years (Ding 2012). As for the proposal to lift the limitation of a maximum of 50% ownership of JVs by MNCs, such a move would indicate the full opening of the Chinese automobile industry to the world. It would also break the backbone of the dominant alliance between the large SOEs and the JVs. While the current coalition structure cannot predict future

policy, the coalition politics that are fought out over policy decisions will be the engine of policy change in the future.

4.5 Conclusion

This chapter analyzes the impacts of fiscal reform on the local economic development model and its subsequent influences on the formation of competing coalitional structures in the auto industry. The tax-sharing reform initiated in 1994 replaced the previous tax-contracting system. This change led to a transformation from “local state corporatism” (Oi 1992) to the “local corporate state.” In “local state corporatism,” local governments acted as boards of directors, so externally they bargained with the governments one level above them to make better fiscal contracts. The central government made deals with the provincial-level governments, and the provincial governments made agreements with the prefectural-level governments. The chain of tax contracts went down to the township governments. Due to such bilateral contracts over tax revenue, the roles of central and local states were undifferentiated. The higher-level governments, even the central government, did not intervene in local administration, as far as local states were able to fulfill the terms of their contracts. The TSS, however, separated the roles of central and local governments by collecting taxes according to tax types. The central government collected the taxes assigned to the central government as well as the bigger portion of the taxes shared between the central and local governments. The central government’s improved fiscal capacity enabled it to take a more active role in protecting the underdogs created by the market reforms. In the realm of economic governance, the central government enhanced its role as an “asset owner” by establishing the SASAC. In contrast, local governments strengthened their roles as “tax collectors” and “institutional investors.”

The transition to “local corporate states” also changed local development models internally. As the cost of directly owning firms increased, the local governments started to diversify their development strategies. Every local government had similar incentives, but their different endowments, which mostly corresponded to their place in the hierarchy, affected the strategies they chose. Once owning firms was no longer lucrative for most of the local states, private auto firms who secured auto production licenses during the massive SOE reforms enjoyed unprecedented leverage on investment-seeking local governments. Even the local governments who held production licenses allowed their SOEs to become investment companies or exploited the value of the license itself. These internal changes of local state development models consolidated the competing coalition structures in the auto industry. While the AIP initially was designed to selectively nurture a small number of large SOEs to become “national champions,” the smaller enterprises that spun off from the SOE reform eventually secured firm support from local governments.

CHAPTER 6

Uneven Endowments, State Intervention, and Varied Forms of Market Competition:

Comparison of the Automobile, Petroleum, and Machinery Industries

6.1 Introduction

In the previous chapters, I analyzed how interactions between market transitional reforms and industrial policy have shaped specific modes of market competition in the auto industry. The policy making for the auto industry, as a pilot industry in China's industrial reform, focused narrowly on the traditional actors in the planning period. The AIP exclusively favored a small, designated number of these actors. The gap between the abundant benefits they received and their failure to reach the expected goals invited new actors to try to enter the auto industry. Recurring government reforms relaxed vigilance, mass SOE reform opened the door to new actors, and fiscal reform rendered the patronage of new actors attractive to lower-level local governments. While industrial policy was actively promoted as a new tool for macroeconomic control in the socialist market economy, complex interactions between the AIP and accompanying macro institutional changes produced unintended outcomes that arose from highly polarized policy coalitions. In transitional China, where the market and the government are being built simultaneously, it is very natural that there are uneven institutional developments across different sectors. Although it was only commonsensical to expect such institutional variation, the Chinese central government attempted to intervene in its designated pillar industries, that is, the machinery, electronics, automobile, petroleum, and construction industries, in a uniform way. In April 1994, the State Council issued "Guideline for National Industrial Policy during the 1990s" (henceforth, the Guideline), which set the main direction of forthcoming industrial policy making.

The Guideline pointed out similar problems in all the pillar industries such as low technology levels, poor product quality, and the dispersion of production capacity, and it proposed the enactment of unified industrial policies for these industries. The auto industrial policy was promulgated in 1994 as the first systematic sectoral industrial policy. Industrial policies separately covering the electronics and machinery sectors, however, did not develop beyond the draft stage, and no attempt was made to enact industrial policies for the petroleum and construction sectors. Furthermore, after two decades of industrial development, these sectors now have totally different market competition structures. The previous chapters' in-depth case study of the auto industry shows that the central state's intervention through auto industrial policies unexpectedly faced fierce coalitional politics, which were ignited by macro institutional reforms. The auto industry itself grew rapidly, but this growth was the outcome of unintended coalition politics rather than effective implementation of the AIP. According to the Guideline, each pillar industry had an equal level of strategic value, and the same growth-promoting policies, in theory, should apply. But in reality, the level of policy enactment and the resulting outcomes vary significantly across the industries. Why was industrial policy not promulgated in the other pillar industries when the automobile industry policy was introduced? Why do the market competition structures of the automobile industry and the other industries differ? By comparing the automobile, machinery, and petroleum industries to answer these questions, this chapter attempts to uncover an understudied industrial governance mechanism of Chinese state capitalism.

6.2 State Intervention and Market Competition

Previous literature tackles the puzzle of China's rapid industrialization from two different approaches. The first approach attempts to suggest alternative governance mechanisms that possibly induce high growth (Breznitz and Murphee 2011; Heilmann and Perry 2011; Rothstein 2015). For example, Rothstein (2015) defined an organizational feature of the Chinese government that is more apt to promote economic development in a transitional context, compared to a Weberian bureaucracy. In the Weberian system, the problem of delegation is solved through the precise application of rules by a civil service. Thus, predictable, rule-of-law-oriented, nonpolitical, and impersonal features are valued in officials. From the perspective of the Weberian bureaucracy, Chinese officials lack these features. Chinese local civil servants selectively implement central rules (O'Brien and Li 1999; Su 2004), and concrete measures of policy implementation are usually open to local experimentation (Heilmann 2008). Furthermore, the pervasiveness of public officials' involvement in corruption and rent-seeking activities have invited suspicion about the reality and sustainability of the Chinese miracle (Ngo and Wu 2009; Wedeman 2012). Rothstein (2015) proposed that China's rapid industrial growth could be explained by the distinctive administrative organizational structure referred to as the cadre system. As an ideal type in the same manner as a Weberian ideal type, the cadre system is also known as the "missionary model" or the "clan model" in the management literature (540). The cadre bureaucracy is a "system in which performance goals and hierarchically ordered mandates are set centrally giving local cadres fairly large discretionary power over how to reach the targets" (538). Thus, for public officials in a cadre system, commitment, flexibility, mandate fulfillment, and performance rationality are the most valuable features. The officials in the cadre system have much more opportunity to make private use of public authority compared to officials in the

Weberian system, but they likely perform better in new and flexible situations. The problem with this explanation is that it only postulates cadres who fulfill their mandates without violating central regulations. However, highly motivated cadres not only creatively interpret central mandates but also frequently breach central orders. Motivated local cadres are frequently uncontrollable; so, collective action dilemmas are one of the salient features of Chinese industrialization (Noble 1998). A common Chinese saying about government organization can be translated as: “When power is centralized, it ends in deadlock; when power is delegated, it ends in disorder.” As the saying implies, high economic performance at the local level does not easily translate into economic development at the national level, due to coordination failure (Huang 2002). The cadre system is more likely to aggravate the problem of coordination failure than to alleviate it.

The second approach explains China’s growth by emphasizing the central state’s “institutional capacity.” For example, China’s automotive modernization was mainly driven by the central state’s capacity over multinational corporations and state-owned enterprises in the automotive industry (Chin 2010). Hsueh (2011; 2015) argued that the Chinese central state deregulates industries with low “strategic value,” such as textiles, while tightening its regulatory power over high “strategic value” industries like telecommunications. While the aggregate characterization of the state as “strong” is useful for crossnational comparisons, as Haggard and Moon (1990) pointed out, it cannot explain variations in state capacity across industries, or vis-à-vis different social groups within a single country. If the state were “autonomous” only from certain marginal groups, policy outcomes could be parsimoniously explained by the preferences of a dominant coalition. The critical test of a strong state’s institutional capacity is whether the state structure can insulate pressures from vested interest groups. To explain the Chinese central

government's strong bargaining leverage with MNCs, Thun (2004) identified two different types of foreign direct investment (FDI) in China: (1) that which relocates manufacturing operations to take advantage of low production costs and (2) that which seeks access to the large Chinese market. FDI in the auto industry is of the second type and in this case, MNCs tend to be more vulnerable to host government pressure in initial negotiations. Thun argued that Chinese-style industrial policy uses "external strength to compensate for certain internal weaknesses" (455) in this regard.

Despite their different points of emphasis, both of these approaches are preoccupied with institutions or institutional capacity. State apparatus and industrial policy, however, are the results of certain political and social processes rather than stand-alone independent variables (Haggard 2004; Kim 2009; Moon and Prasad 1994). Rather than directly affecting economic performance, state intervention can only induce certain forms of market competition, and the forms of market competition subsequently result in development performance.⁵³ The case of the auto industry as examined in the previous chapters shows the illogic of attributing its rapid growth to the nature of the state apparatus or its industrial policy: The relevant governmental organizations have been continuously reshuffled and the auto industrial policy failed to achieve its original goals. Nonetheless, macro institutional reforms facilitated an unexpected rise of competition between two coalitions, the SOE-led incumbents and the private and subprovincial newcomers. It is this competition that has resulted in the Chinese auto industry's rapid growth.

From the case of the Chinese auto industry, we can infer that between a *laissez-faire* market and a state-led development, there still exists a huge amount of room, which is what made development possible. As Dani Rodrick (2007) suggested, there might be "many recipes"

⁵³ At the risk of excluding various antecedent and intervening variables, we can posit a linear causal chain for the interaction between state intervention and development, as follows: political/social process → state apparatus and its industrial policy → forms of market competition → economic performance.

for development rather than a single “best practice.” The different recipes, of course, lead to different performances. For example, in the state-dominant South Korean development case, the state’s effective maintenance of performance standards for evaluating “national champions” by pegging performance to export achievement made it easier to winnow out the losers in a given industry. South Korea’s institutional setting also led the national champions to focus their attention on competing with foreign incumbents in international markets, rather than competing to seize the domestic market (Amsden 1989). The market competition that arose in the Chinese automobile industry is one mechanism that was located in the space between the dominant state and the laissez-faire market. To draw a more sophisticated picture of the relationship between state intervention and market competition in transitioning China, this chapter expands its focus beyond the auto industry.

6.3 Case Selection and Analysis Strategy

6.3.1 Case selection

The State Council issued “Guidelines for National Industrial Policy during the 1990s ” in April 1994. The Guideline diagnosed similar industrial problems in all the pillar industries; hence, it proposed enacting unified industrial policies for them. For example, the Guideline recognized problems in the machine building, petrochemical, and automobile sectors as follows:⁵⁴

Machinery industry:

With key basic machinery, basic components, and major complete technology sets of equipment as the focus, the machinery industry should promote optimization of

⁵⁴ For a more complete diagnosis on each pillar industry by the SPC-led project team, see Zheng 1995.

production structure, and improve the levels of industrial technology and competitiveness.

Petrochemical Industry:

The petrochemical industry should actively promote large-scale production, improve the technical level, and deepen processing techniques.

Automobile Industry:

The automobile industry should reduce the number of factories as soon as possible, [and focus on] a high-volume production system, orderly competition in the market structure, improving its domestic market share, and international competitiveness.

As tangible targets, the Guideline also suggests that the industries should: (1) improve production concentration rates, (2) strengthen self-development capacity, and (3) improve international competitiveness and exports. Despite the State Council's uniform view of the pillar industries, the actual enactment of industrial policies in these industries has varied significantly. As we know, the automobile industry was the first for which a sectoral industrial policy was promulgated. In contrast, in 1994, a draft version of a machine industrial policy sent to the SPC and later to the State Council, but the draft was abandoned without passing review. Only in 2006 did the State Council release an opinion, with much narrower scope, regarding the equipment manufacturing industry.⁵⁵ In the electronics industry, as of 2000, major policy makers spent seven years attempting and failing to draft an industrial policy. On the other hand, industrial policy making for the petroleum and construction industries has not even been attempted. (See

⁵⁵ "Several Opinions of the State Council on Accelerating the Rejuvenation of the Equipment Manufacturing Industry" (February 13, 2016). http://www.gov.cn/zhengce/content/2008-03/28/content_3083.htm

Table 6-1.) Li Shousheng, deputy director of the Department of Industrial Policy at the SETC, summarized three difficulties of industrial policy: it is “difficult to enact (*zhidingnan*), coordinate (*xietiaonan*) and promulgate (*chutainan*)” (Li 2000, 51).

Table 6-1. Status of Industrial Policy Drafting, Reviewing, and Promulgation

| | |
|-------------------------|--|
| Automobile | Automotive Industrial Policy (1994) Automotive Industry Development Policy (2004) |
| Machinery | A draft of a Machinery Industrial Policy was sent to the SPC in 1994 and later to the State Council for review, but abandoned in the review process. In 2006, the State Council released an opinion regarding the equipment manufacturing industry (<i>zhuangbei chanye</i>). |
| Electronics | As of 2000, over seven years spent on a failed attempt to draft a policy. |
| Petroleum, Construction | Never attempted. |

Summarized by author from Li (2000).

Furthermore, after two decades of market reforms, each industry has been reorganized into a very different form. Because industrial policy aims at restructuring the supply-side of production capacity, the sources of investments in fixed assets in the pillar industries would be more or less similar if the pillar industries had been restructured according to the Guideline. As Table 6-2 shows, however, investment in fixed assets varies across sectors. The fixed asset investment in the upstream petrochemical and gas extraction sector is dominated by central SOEs. Centrally managed and state-holding firms account for 79.5% and 93% of total fixed-assets investment shares. On the other hand, the most privatized sector is that which manufactures special purpose machinery, a high value-added sector of the machinery industry. Centrally managed firms account for only 2.1% and private-holding firms for 75.2% of total fixed-asset investment in this sector.

Table 6-2. Investment in Fixed Assets (Excluding Rural Households) by Sector, Jurisdiction of Management, and Holding Type (2012)

| | Jurisdiction | | State-Holding | Collective Holding | Private-Holding | Funds from HMT* | Foreign Funds |
|--|--------------|-------|---------------|--------------------|-----------------|-----------------|---------------|
| | Central | Local | | | | | |
| Petroleum/Gas Extraction (B07) | 79.5 | 20.5 | 93 | 0.4 | 3.7 | 1.3 | 1.2 |
| Petroleum/Nuclear Processing (C25) | 22.7 | 77.3 | 32.8 | 3.9 | 52.5 | 1.6 | 8 |
| Automobile Manufacturing (C36) | 5 | 95 | 18.6 | 5.3 | 56.5 | 2.6 | 15.2 |
| Special Purpose Machinery (C34) | 2.1 | 97.9 | 8.7 | 4.6 | 75.2 | 1.7 | 5 |
| Computers, Communications and Other Electronic Equipment (B39) | 1.2 | 98.8 | 15.9 | 2.3 | 51 | 12.3 | 14.4 |
| Construction (E47-E50) | 5.2 | 94.8 | 58.3 | 9 | 22.4 | 0.8 | 0.4 |

Source: China Statistical Yearbook 2013 (170–171). Calculated by author.

Notes: Unit: %. Industrial classification code numbers according to the GB/T 4754-2011 are in parenthesis.

* Funds from Hong Kong, Macao, and Taiwan.

This chapter will conduct a comparative analysis on the machinery, petroleum, and auto industries. These industries were selected as cases because of methodological and empirical considerations. First, by selecting cases with large variation in the actual enactment of industrial policy, this chapter first answers why the efforts to apply similar industrial policies have been different. Analyzing the industries in which the enactment of policy was as different as possible helps control for the effects of industrial policy. Second, these three industries' market competition structures vary significantly as well. Among the pillar industries, the machinery sector is the most privatized and the petroleum sector is the least privatized. By investigating the industries at these two extremes, this chapter attempts to draw a more elaborate picture of state-market relations in Chinese state capitalism.

The classification of industry in China has changed continuously.⁵⁶ To ensure comparable figures across industries, this chapter defines each industry according to the most up-to-date Industrial Classification for National Economic Activities (GB/T 4754-2011), which is standard for all national statistics in China.⁵⁷ For the convenience of analysis, only the petroleum sector of the petrochemical industries is analyzed. The machinery industry covers a broad range of activity, so it is difficult to limit its scope. For example, even the equipment manufacturing industry, which the State Council's 2006 opinion targeted as having a much narrower scope, includes the manufacture of: (1) metal products (B33); (2) general purpose machinery (B34); (3) special purpose machinery (B35); (4) railway, ship, aerospace, and other transport (B37); (5) electrical machinery and apparatus (B38); and (6) measuring instruments and apparatus (B40).⁵⁸ A new term for the equipment manufacturing industry, the “high-end equipment manufacturing industry” (*gaoduan zhuangbei zhizao chanye*), has been used as part of the new designation of “strategic emerging industries” (*zhanluexing xinxing chanye*).⁵⁹ The national Bureau of Statistics also released new classification standards for strategic emerging industries in 2012.⁶⁰ While the high-end equipment manufacturing industry spans various categories such as the manufacture of railway, aerospace, and other transport equipment (category B37) and of measuring instruments and machinery (category B40), it is concentrated in the manufacture of special purpose machinery (category B35). Hence, this chapter focuses on the special purpose machinery manufacturing sector as a proxy to measure the performance of the machinery industry.

⁵⁶ This classification standard for industry was first set up in 1994 (GB/T 4754-1994), and revised twice, in 2002 and 2011.

⁵⁷ National Bureau of Statistics of the People's Republic of China, <http://www.stats.gov.cn/tjsj/tjbz/hyflbz/>

⁵⁸ Equivalent industrial classification code numbers are in parenthesis.

⁵⁹ The term “strategic emerging industries” has been in use since 2010 (http://www.gov.cn/zwgk/2010-10/18/content_1724848.htm). On the State Council's most recent direction regarding the strategic emerging industries for the period of the 13th Five-Year Plan, see http://www.gov.cn/zhengce/content/2016-12/19/content_5150090.htm.

⁶⁰ <http://www.stats.gov.cn/tjsj/tjbz/201301/U020131021375903103360.pdf>

6.3.2 Analysis strategy

It has been argued in the political economy literature that sectoral characteristics cause variations in the state's roles and policies, not vice versa. According to Evans (1995, 81), "sectors are more than just arenas for observing specific kinds of state involvement, because their techniques of production, forms of industrial organization, and *modes of governance* vary systematically." Among many other factors in sectoral variation, D. Michael Shafer (1994) emphasized the specific economic organization embedded in sectors. Despite their distinct sectoral characteristics, the Chinese central government, however, adopted industrial policy as a unitary method for promoting the pillar industries. When the same method is applied to different sectors, it is very natural to have different outcomes. As Steven Vogel (1996) pointed out, while ideas and institutions are interrelated, each has evolved at a different pace and has independent effects on policy outcomes. Although Chinese industrializing elites adopted an idea to enact industrial policy to promote the pillar industries in the early 1990s, each industrial sector had distinct institutional endowments. The institutional gaps between the different pillar industries inevitably resulted in different patterns of coalitional politics and market competition.

What can we learn by comparing three sectors that we expect to have different policy outcomes? Despite different sectoral characteristics, each industry has gone through similar macro institutional reforms. The unique forms of industrial organization embedded in the sectors have changed along with these same institutional reforms. This chapter does not deny the important role of sectoral characteristics in shaping modes of industrial governance, but demonstrates that certain forms of market competition in each sector are also shaped by interaction between interventionist industrial policy and macro institutional reforms. In other words, sectoral characteristics alone do not determine current forms of governance or modes of

governance. As shown in the previous chapters, industrial growth has usually occurred in tandem with increased concentration ratios due to the effects of economies of scale in the auto industry. However, the majority of Chinese auto firms are still operating at much lower levels than the minimum needed for economy of scale (Huang 2002). Instead of emerging from common sectoral traits, the deviating performances of Chinese auto firms largely resulted from their unique experiences of the Chinese market transition. The automobile industry's case suggests the possibility that the sectoral variation in policy enactment and market competition in these three pillar industries could be caused by the same interactive mechanism between industrial policy and macro institutional reforms, despite sectoral differences. Hence, as a comparison strategy, this chapter takes the critical mechanism affecting the auto industry that the previous chapters described, and tests its validity for the other two sectors.

From the case study of the automobile industry, we learned how the macro institutional changes that accompanied the establishment of the socialist market economy exerted decisive effects on the implementation of the auto industrial policy and its results. First of all, administrative reform to separate state and business (*zhengqi fenkai*) determined the industrial players who would have decisive power on the path of future reform. Among numerous administrative reforms, the establishment of an administrative corporation (AC, *zonggongsi*) was particularly important. As shown in chapter 3, the establishment of the CNAIC (China National Automotive Industry Corporation), the administrative corporation in the auto sector, gave the industry's business management, which previously had been done by administrative organizations, to economic organizations for the first time. These ACs were short-lived institutions, but their establishment rearranged the major *veto players* in the industries at the central state level. Second, state-owned enterprise reforms, especially during the Zhu Rongji

period's program known as "grasp the large, let go of the small" (*zhuada fangxiao*), actively drew *boundaries* that established where nontraditional actors could operate. What industries and companies the central state was trying to grasp had a decisive impact on who would take the lead in the specific industries. Finally, central-local fiscal reforms along with banking reforms rearranged what had once been very closed subprovincial state and local SOE relations. After the 1994 Tax Sharing reform, rather than "acting as the equivalent of a board of directors" for all SOEs, local governments began to focus on industries that had potential for high GDP growth, tax revenue, employment, and profit-generating effects. Given the importance of local governments' stances in the central government's policy implementation, the *stance* of local governments toward particular industries had a significant impact on the central government's industrial policy making. Table 6-3 summarizes these three mechanisms in regard to each sector.

Table 6-3. Automotive, Petroleum, and Machinery Industries: Number of Central Veto Players, Level of Central State Control, and Local Governments' Stance towards the Sector

| Sectors | Number of Central Veto Players | Level of Central State Control | Local Governments' Stance towards sector |
|------------|--------------------------------|---|---|
| Automobile | 1 | Relatively Strong | Continuous active involvement |
| Petroleum | 3 | Absolute | Changed from active involvement to indirect participation around 1996 |
| Machinery | 0 | Weak in overall sector, relatively strong in the equipment manufacturing sector | Changed from neutral to eager to sell machinery SOEs around mid-2000s |

Owing to China's unique *tiao-kuai* system, it is the number of veto players that primarily affects the outcome of policy enactment. China's unique delegation system led to a pattern of detaching economic organizations important in industrial policy enactment, such as ACs, from

the government during the 1980s. Susan Shirk, in her classic study of Chinese institutional reforms, called this unique system “delegation by consensus”:

The CCP delegates to the State Council the authority to make specific economic decisions. The State Council leaders at the top of the bureaucratic hierarchy delegate to their subordinates the authority to make decisions *if* the agents can agree. If the agents reach consensus, the decision is automatically ratified by the higher level; if the agents cannot agree, then the authorities step in to make the decision, or the matter is dropped or tabled until consensus can be achieved. Delegation by consensus is practiced at each level of the organizational hierarchy. State Council to commissions, commissions to ministries and provinces, ministries and provinces to bureaus and cities, and so on. (Shirk 1993, 116)

Policy-making under a system of delegation by consensus tend to be very time consuming and incremental. As a corollary, according to Shirk, “when the authorities are divided and their preferences uncertain, agents are less willing to compromise and agreement on policies is more difficult to achieve” (128). Because the ACs that had functioned as central veto players worked on behalf of the sectors’ interests in the early period of the SME, the pattern of AC formation is critical to the question of industrial policy enactment. Once policy has been enacted, the central government has participated in the policy implementation process only indirectly; for example, as a macroeconomic regulator through the NDRC or the largest shareholder of the central SOEs through the SASAC. Thus, the quality of policy implementation is largely determined by ongoing SOE reform and the stance of local governments towards the sectors.

6.4 The Petroleum Industry

The petroleum industry has been criticized as one of the most monopolized in China. Since 1998, the Chinese petroleum industry has reorganized into an oligopolistic market dominated by three giant national oil companies (NOCs). The CNOOC (China National Offshore Oil Corporation) focuses on exploration and development of crude oil and natural gas in offshore China. The two large integrated onshore giants, CNPC (China National Petroleum Corporation; parent company of PetroChina) and China Petrochemical Corporation (CPC; parent company of Sinopec), operate in business areas that range from upstream oil and gas exploration to downstream refining and retailing, roughly demarcated along the territorial boundary of the Yellow River (Lin 2008, 68). Out of about a hundred central SOEs, these three NOCs accounted for about 65% of SASAC firms' total profit as of 2010.⁶¹ From the upstream business of exploration and mining, to the middle stream of gasoline and diesel refining, and to the downstream of wholesale and retail, the two listed arms of the NOCs, PetroChina and Sinopec, are making huge profits from their oligopolistic positions. In the absence of an independent regulatory agency, the NOCs are functioning as de facto regulators by controlling import and export quotas and pricing mechanisms (Shi, Weng, Lin, and Zhu 2012).

The oligopolistic status of the NOCs is sustained by two important mechanisms. Critics of the NOCs' oligopoly in the petroleum industry have pointed out that if the monopoly on crude oil is a "glass door" that prevents private companies from entering the market, the pricing mechanism is a "revolving door" that drives out private companies who are already operating in

⁶¹ As of 2010, CNPC, CPC, and CNOOC recorded net profits of 85.227 billion CNY, 12.418 billion CNY, and 7.212 billion CNY, respectively, out of a total 160.135 billion CNY. For central SOE profit data, see: <http://www.sasac.gov.cn/2009rdzt/fj.htm>; <http://www.sasac.gov.cn/n86302/n326735/n326745/c1009299/content.html>; and <http://www.sasac.gov.cn/n1180/n1566/n258203/n259490/13878095.html>.

the oil industry (Shi et al. 2012). First, the three NOCs are controlling the supply-side of crude oil. Oil and gas exploration rights are exclusively distributed to these three NOCs based on geographical boundaries, that is, offshore, onshore north, and onshore south. All domestic crude oil production is distributed exclusively through them. As a WTO commitment, China was required to allocate trade import quotas to nonstate companies of 4 million tons of refined oil and 7.2 million tons of crude oil in 2002, both of which were intended to increase by 15% annually for the next 10 years. The former SETC, however, announced that imported crude oil, which fell under the nonstate quotas, should be refined in facilities run by Sinopec or PetroChina. Because all imported crude oil should be refined and distributed domestically through the channels of the NOCs, the profit margins of private companies in overseas exploration or crude oil imports are very low (Shi et al. 2012).

Second, after the announcement of the “Proposal for the Reform of Crude and Refined Oil Prices,”⁶² in June 1998, the Chinese central government changed the benchmarks of price fluctuations several times, but the principle that the government sets the prices has never changed. Regulatory systems vary greatly across sectors in the contemporary China (Pearson 2005; Tsai 2011); in the petroleum industry, government management functions such as pricing were handed over to the corporatized NOCs. As shown in Table 6-4, the three current NOCs developed from administrative corporations (*zonggongsi*). Between 1978 and 1988, the Ministry of Petroleum (MoP) was in charge of the petroleum industry. Besides the MoP, however, the Ministry of Chemical Industries (1978–1998) and the Ministry of Textiles (1978–1993) also had petroleum-related firms under their control. In 1982, the CNOOC was established as the AC responsible for the drilling of offshore oil resources. In 1988, the China Petrochemical Corporation, the second AC in the petroleum sector, was established by merging 39 oil-related

⁶² http://www.nea.gov.cn/2011-08/16/c_131051983.htm

firms from the Ministries of Chemical Industries and Textiles. Finally, in 1988, the MoP was abolished and the remaining production firms under its control were converted to the CNPC. For more than a decade since 1998, China's oil industry was sustained by three major ACs: CNOOC for offshore exploration, China Petrochemical Corporation largely for refining, and CNPC for onshore exploration and refining. The last two ACs also controlled important government functions, such as pricing, so there was no incentive for creating an industrial policy that would cover the entire sector.⁶³

Table 6-4. The Formation of the Three National Oil Corporations

| Parent Company | Listed Arm | Institutional Background |
|--|---------------|---|
| CNOOC (China National Offshore Oil Corporation) | CNOOC Limited | Established in 1982 as an AC Listed in Hong Kong in 1999 and New York in 2001 |
| CNPC (China National Petroleum Corporation) | PetroChina | Established in 1988 as an AC; the production units of MoP were converted to the CNPC Corporatized to the CNPC in 1998 |
| China Petrochemical Corporation | Sinopec | Established in 1983 as an AC from merging 39 petrochemical firms Corporatized to China Petrochemical Corporation in 1998 |

Despite the current oligopoly of central SOEs in the petroleum sector, the central state's early efforts to take back central control in 1993 faced strong resistance from major oil companies and local governments.⁶⁴ In 1994, the Guideline suggested enacting industrial policy to overhaul the petroleum industry, but no attempt to draft a unified industrial policy covering the petroleum industry as a whole has been made. The failure of centralization efforts in 1993

⁶³ On government organizational reforms affecting the petroleum industry, see Ji (2014, 56–61). And for a brief history of 39 years of reform in the petroleum industry, see:

<http://www.cnpc.com.cn/syzs/ktkf/201309/9f9d9248d46a4723bb43a6ad98efb1de.shtml>,
<http://www.cnpc.com.cn/syzs/ktkf/201309/02555e4f98a6400597e1b239d33a8728.shtml>.

⁶⁴ For a more detailed analysis of centralization efforts in 1993, see Lin (2008, 58–67).

and the absence of industrial policy making largely resulted from the mode of industrial governance at that time. At the central level, the three NOCs partitioned the market on a geographical basis. At the local level, provincial governments also actively participated in oil extraction, refining, and distribution. High profit margins caused by the shortage economy at that time satisfied all participants and maintained the equilibrium of decentralized industrial governance.

A change in the status quo, however, was facilitated by a structural imbalance caused by a plunge in crude oil prices and China's shift to an economy of surplus. In the chronic shortage economy, central and local SOEs as well as local governments exploited rent-seeking opportunities by arbitrating between the plan and the market prices. However, in 1996, China's shift from an economy of shortage to one of surplus drastically reduced rent-seeking opportunities and led to heavy indebtedness of SOEs and local governments. (For a detailed discussion of the situation of the petroleum industry during this period, see Lin 2008, 67–76.) Only in the late 1990s, when local governments experienced serious losses in the oil industry, could centralized attempts to manage the petroleum sector be undertaken. If the petroleum industry had continued to be highly profitable, and the NOCs and local governments had been able to secure these high profits, then breaking the decentralized industrial governance structure might have been impossible. In contrast to the rise in debt-ratios of the NOCs and local governments, the central government had improved its fiscal capability through the 1994 tax-sharing reform. These conditions helped to break the existing equilibrium. The previous three large administrative groups corporatized into vertically integrated business groups that controlled every aspect of the industry from crude oil production to refining and distribution.

6.5 The Machinery Industry

The machinery and automotive industries have been traditionally controlled by the same central ministry. When the auto industrial policy was released in 1994, there were also calls to draft a machinery industrial policy. For example, an official in the division of industrial development in the Ministry of Machine Industry published an article, “Why Should We Formulate a Machinery Industrial Policy?” (Zheng 1994). As had been done with the AIP, a review draft of a machinery industrial policy was sent to the SPC in 1994. The specific goals specified in the review draft were also very similar to those in the AIP.⁶⁵ In 1993’s government organizational reform, the Ministry of Machine and Electronics Industries (1988–1993) was divided into the Ministry of Machine Industry and the Ministry of Electronics Industry. Since 1993, however, the direction of reforms to separate government and business shifted to reducing the central government’s intervention in industry and establishing administrative corporations. Unlike in the automobile and petroleum industries, no AC was established in the machinery industry. Due to the absence of an institution to act as a sponsor of industrial policy making, the machinery industrial policy that had been drafted and reported to the State Council did not get past the last hurdle.

The situation of lacking an institutional base for industrial governance in the machinery industry continued. In 1998, the Ministry of Machine Industry was relegated to the Bureau of Machinery under the newly established SETC, but as shown in chapter 3, the Bureau did not have any capacity to govern the industry beyond the relocation of personnel. When the Bureau was finally abolished in 2001, the remaining industrial management functions were transferred to

⁶⁵ Some of these specific goals are:

1. Increase the production concentration ratio from the current 18% to 25%. Nurture large corporations with international competitiveness and cultivate 5 business groups with sales of more than 10 billion CNY, and 30 groups with sales of more than 1 billion CNY.
2. Improve self-innovation capabilities. Increase domestic sources of technology from 25% to 40%.
3. Improve the competitiveness of the machinery industry in the international market. Make machinery industry exports account for more than 20% of total exports and become China’s largest export industry (Zhao 2012, 156–157).

the China Machinery Industry Federation.⁶⁶ In the absence of an institutional base to represent the interests of the machinery industry, the machinery industry began to be classified as a “competitive industry.” This situation led to active mergers and acquisitions of state-owned machinery firms by foreign and private capital. Except in a very few strategic areas, state-owned holdings are no longer the main forces of the machinery industry. Already in 2006, non-SOEs accounted for 75% of the total output of the machinery industry (Zhao 2012, 197–198).

If the Guideline had been uniformly applied to the machinery industry or if there had been a strong institutional sponsor to pass and enforce the machinery industrial policy, then there might also have been active government efforts to foster national champions with careful protection from foreign capital. The Chinese central government’s intervention, however, was far from active, but was reactive. When, in 2006, forerunner Chinese machine firms became the targets of mergers and acquisitions by foreign capital, the Chinese central government rushed to designate an “equipment industry” (*zhuangbei chanye*), defined as “basic industries that provide technical equipment for national economic development and national defense construction.”⁶⁷ In 2005 and 2006, the German FAG had purchased 49% of the stakes owned by Xibei Bearing Group in their JV, the American Carlyle Group attempted to merge with the Xuzhou Construction Machinery Group (Xugong Group: XCMG), the German Schaeffler tried to purchase Luoyang Bearing, the American Caterpillar planned to acquire Xiagong, and so on. The deals made between local governments and foreign capital, however, were soon to be probed by the State Council. One executive involved in the German Luoyang deal said:

There is a fundamental debate going on in China at the moment about which

⁶⁶ <http://cmif.mei.net.cn/>

⁶⁷ “The State Council’s Several Opinions on Accelerating and Revitalizing the Equipment Manufacturing Industry,” released on June 29, 2006 (http://news.xinhuanet.com/newscenter/2006-06/28/content_4763768.htm).

industries should be protected as they are in the national interest. The investigation is not so much about the deal itself but this wider debate and the talks are being held at a very high level. (Dyer and Milne 2006)

In the absence of regulations on the entry of foreign capital into the Chinese market, local governments who were experiencing financial difficulties negotiated directly with foreign MNCs. Increased competition from private companies required more investments in local machinery SOEs to make technological upgrades. For example, Xiangong, one of Xiamen's largest SOEs and China's largest heavy machinery makers, also recorded a decrease of net revenue from 79.41 million CNY (US \$9.9 million) in 2003 to 33.28 million CNY (US \$4.16 million) in 2005. In addition, the company's huge bank loans to expand their production capacity negatively affected their return rate (Ji n.d.). Financially troubled local governments began to sell their local machinery SOEs, because the machinery sector was not profitable, and central regulation of market entry was loose. In the Caterpillar-Xiangong deal, the former insisted on only purchasing Xiangong's share in the listed-arm, but the Xiamen government pressed it to a buy-out of the entire group.

The series of deals to sell the Xugong Group, one of China's largest construction machinery makers, to Carlyle triggered widespread concerns over national security in China. Xiang Wenbo, the CEO of SANY, which also made a bid to merge with Xugong, circulated his criticism on the internet, arguing that the deal meant the "loss of state-owned assets" through the selling off of Xugong at a low price. To lessen the opposition, the Carlyle Group revised its bidding conditions, but this event eventually led to the involvement of the Departments of Commerce of both the United States and China. The U.S. undersecretary of commerce, Frank

Lavin, urged China to approve the Carlyle-Xugong takeover deal. China's Ministry of Commerce also held a hearing about the deal, but the Chinese government concluded that this foreign capital investment in the machine industry would have a negative impact on national security and national economic security. Finally, on August 9, 2006, the Ministry of Commerce released "Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors" and invalidated takeover deals between local governments and foreign capital.⁶⁸

6.6 Conclusion

By analyzing two more pillar industries, this chapter attempts to draw a more nuanced picture of Chinese industrial governance. Comparing the petroleum, machinery, and auto sectors offers three important lessons. First, China's central state could not lead industrial development in the direction they wanted. The central reformers adopted the idea that promoting industrial policies would be a suitable way to develop the pillar industries, but even the policy making was not done as they had hoped. In the industrial restructuring of the last few decades, even in the petroleum industry, which best represents the "advancement of the state" (*guojin*), the central state's centralization scheme failed initially, only succeeding after the local states' incentive structures had changed. As analyzed in previous chapters, the rapid growth of the auto industry also arose despite the industrial policy, from unintended competition between two coalitions. Machinery was designated a protected industry only after attempts at mergers and acquisitions of large local SOEs by foreign capital became visible; the central state reacted, but only by protecting a small sector within the machine industry, which was given the new label of high-end equipment manufacturing (*gaoduan zhaungbei chanye*). These cases confirm that the state-led development model in the literature on the developmental state, which is mainly drawn from the cases of

⁶⁸ <http://www.mofcom.gov.cn/aarticle/b/c/200608/20060802839585.html>

Japan, South Korean, and Taiwan in the 1980s and 1990s, cannot explain Chinese industrial growth.

Second, in China's transitional economy, institutional conditions at critical junctures inherited from the planning period have also shaped the subsequent paths of market reform. While the 1994 Guideline suggested promulgating industrial policies in all the pillar industries, it only happened in the auto sector. As analyzed in the previous sections, too many veto players in the petroleum industry and no sponsoring institution in the machinery industry both led to the failure of industrial policy promulgation. Only in the auto sector, which had a single administrative corporation, was there a successful release of a sectoral industrial policy. The establishment of administrative corporations in the auto and petroleum sectors was mainly determined by the organizational structures inherited from the planning period.

Finally, this dissertation's case studies on the automobile, petroleum, and machinery sectors warn against both economic and state deterministic approaches to economic development. As shown by Karl Polanyi and succeeding institutional scholars, state-building and market-building are not mutually exclusive, but interconnected processes. Hence, institutional conditions constrain both the available means of state intervention in the economy and the formation of market structures. For example, China's central state's initial scheme to enact industrial policy in all the pillar industries was frustrated by institutional conditions. No government possesses the means to always accomplish its will. Furthermore, markets are not created in an institutional vacuum. In the real world, there is no "big bang" that completely annihilates an existing institutional framework—which is why it is necessary to examine how the state and market interact rather than trying to decide which of them is definitive.

CHAPTER 7

Conclusion

Drawing on primary archival sources and in-depth interviews from eighteen months of field research in China, this dissertation demonstrates that China's attempt to promote industrial policy as a new mode of macroeconomic management to build the socialist market economy ended up failing. Even with the deficient functioning of market mechanisms or state institutions, if a state's policy intervention can dismantle the previous status quo and bring in even limited market competition, it can open up some space for development. In the auto industry, the promulgation of industrial policy settled the "credible commitment problem" of doing business in China. At the same time, macro institutional reforms led to important institutional changes such as central government organizational structures, state-business relations, and central-local fiscal relationships. Strengthened control by the central government through macro institutional reforms, ironically, unleashed market mechanisms that had been suppressed by the local governments, eventually enabling expanded market behaviors. As a result, a new type of business actor and local governments were freed to form a new coalition that challenged the existing structure of China's auto industry. The rise of market competition between rival coalitions, although limited, had the unintended effect of promoting rapid growth.

Three decades after its initial implementation, China's auto industrial policy has had mixed results. As a whole, the auto market avoided encroachment by imported vehicles, but the central state's intervention inflated automobile prices, which subsequently stimulated various new actors seeking high profit rates to enter the auto sector. Localization requirements intended to achieve import substitution increased local parts production dramatically, but also drove

China's major auto enterprises to focus on developing parts supplies instead of developing independent models (Thun 2006). Large SOEs, which benefited from preferential policies, reaped their profits mainly from JVs and failed to realize the goals set by the industrial policy. Meanwhile, various new actors were able to enter the auto industry by purchasing nontransferable "production licenses" from the small and medium SOEs that spun off from former SOEs. In the meantime, the designated large SOEs that remained to enjoy the most preferential policies degenerated into parts producers for their JV partners, but the fledgling domestic actors, who violated industrial policy to access the lucrative auto sector, eventually became the main forces in auto exports with their own brands. In other words, growth-promoting industrial policies failed to realize the policies' intentions but nonetheless produced rapid industrialization outside the policies' scope.

This case study of the Chinese auto industry shows that in a transitional economy where the state and the market are still forming, and the relationship between the two is being re-established, emphasis on either market efficiency or state capacity can be misleading in an explanation of industrial development. China's socialist market economy has never allowed the "spontaneous order" of the market suggested by Hayek (1973), instead only allowing the market to function where the public economy is not working. Industrial policy in China's SME defines the extent to which the state can allow the operation of nonpublic actors in the pillar industries. The primary rationale for state ownership in the pillar industries is that a certain amount of economic and material capacity in the form of SOEs is the base structure that undergirds the socialist superstructure. But when state-owned auto companies degenerated into parts producers for their JV partners, the fledgling domestic firms that held their own intellectual property rights were able to win much broader public support. In the discussion of development problems,

controversy swirls around whether government failure or market failure produces the more rampant and critical obstacles. In the case of the Chinese auto industry, however, both government and market failures were extensive, despite the rapid growth. Although the auto industrial policy created more government failure problems by allocating higher rents to a few designated firms, it unintentionally enhanced market competition to some extent by enabling challenges from the new coalition. When lack of investment is a major cause of underdevelopment, any state action that can bring in sufficient investment and market competition can kick off development.

Based on my empirical research on China's growth in the auto industry and my comparison of industrial governance in the auto, petroleum, and machinery sectors since 1993, in this chapter I will discuss the dynamics of the relationship between state and market, with particular reference to the political process framework. In the following sections, I will first clarify this study's theoretical and methodological implications, and I will then illustrate some features of the substantive working mechanisms in China's state capitalism.

7.1 Theoretical Implications

Theoretically, the case of the Chinese auto industry's rapid growth amid failed policies challenges both market efficiency and state-led development proponents. Both approaches have argued for a version of the "golden straitjacket" to which individual states must put on in order to achieve economic prosperity. However, as Dani Rodrik (2007) suggested, it seems that there is no single recipe for economic development. All late-developing countries confront similar institutional problems in the industrialization process, but because every society involves different social contexts, "one size fits all" institutional solutions can hardly be expected to bring

fruitful results. In the case of the Chinese auto industry, despite huge differences in institutional settings, the Chinese central government followed the lessons of the East Asian developmental states and promoted DS-style industrial policy. China's auto industrial policy has failed, as expected, but the industry itself, unexpectedly, has grown rapidly, despite the fact that the recipe for state-led development never worked in China as it did in Japan and South Korea.

This dissertation's findings also challenge market proponents, particularly the "plan to market" narrative or "transition orthodoxy," in regard to the relations between the state and the market. The historical process of Chinese market building, especially after the socialist market economy was initiated, confirms the positive, mutually supporting relationship, between state intervention and market expansion. The Chinese central government's continuous intervention has facilitated rather than constrained market functions in overall resource allocation. The situation corresponds to Steven Vogel's (1996) "freer market, more rules" proposition. Even in an advanced market economy, running a freer market requires more backing from rules that must be made by the state's action. Before the socialist market economy, the central government let local governments do whatever they wanted as long as they met their fiscal contracts. Because the local governments functioned as de facto boards of directors in their territories, their presence suppressed market mechanisms during the early reform period. Since embarking on the socialist market economy, the central government has enhanced its fiscal capacity, more consistently exercised macroeconomic control, and strengthened its control over the central SOEs as the largest shareholder. Ironically, this strengthened control by the central government unbound market mechanisms that had been suppressed by the local governments, and finally enabled expanded market behaviors by local governments, subprovincial local SOEs, and private actors.

7.2 Methodological Implications

This dissertation employs a political process framework that captures the unexpectedly dynamic coalitional politics revolving around the central state's industrial policies. Contrary to the proponents of state-led development and institutional approaches that specify the effects of state institutional structures on economic performance, this approach allowed me to investigate how auto industrial policy worked in combination with other institutional changes to build the socialist market economy. While previous debates about China's automobile industry have focused on normative aspects by asking whether effective industrial policy making and implementation is possible in China (Chin 2010; Chu 2011; Eun and Lee 2002), this study opens empirical space for the real politics that accompanied the auto industrial policy.

Because the industrial policy was adopted as part of a package that included other institutional changes to establish the socialist market economy, the approach taken in this study is better suited to the fast-changing Chinese terrain than any ahistorical approach could be. Furthermore, this study's political process framework better captures the "nested, hierarchical setting" of central-local relations in China (Wong 2009, 111). Previous studies on China's central-local relations mostly neglect the hierarchically nested character of Chinese administrative systems. Scholars tend to emphasize either the role of the center or the role of the local without considering the nested structure of the local states. For example, Chin (2010) emphasized the Chinese central state's strong capacity over MNCs compared to many South American countries such as Brazil and Argentina. In contrast, Thun's (2006) study of the development of the Chinese auto industry, which considers the huge variations among auto SOEs in terms of supply procurement, highlighted how the role of local states resulted from China's bureaucratic organization and dominant form of interfirm relations. However, as the case studies

in chapter 5 demonstrate, local states' endowments vary according to their place in the hierarchy, and this hierarchically uneven distribution of endowments led to different local development strategies.

7.3 Chinese State Capitalism

Although it is not generalizable to all Chinese industries, this dissertation's case study of the auto industry and comparison of the auto to the petroleum and machinery industries demonstrates some features of Chinese state capitalism. As shown in chapter 4, Chinese economic reform is modeled on the dualistic Marxist structure comprising a superstructure and a substructure. This dualistic structure is ingrained in business groups and overall industry in China. The large SOEs, particularly the traditional Big Three that ranked in the 2015 Fortune Global 500—SAIC (66), FAW (107), and Dongfeng (109)⁶⁹—are, in the eyes of the SASAC, the backbone of the CCP's reign. Therefore, the SASAC initiated several reforms to enhance its control over these large central SOEs through corporatization and financialization. Recently, the SASAC launched an experiment in establishing boards of directors to improve corporate governance (Yeo 2013). To tighten its control, the SASAC began to dispatch outside directors to parent companies. For instance, the FAW's board of directors was first established in April 2013. Of its seven board members, three were selected from the FAW leadership and four were outside members appointed by the SASAC. Despite this kind of corporate governance reform, corruption scandals among high executives are unceasing. For example, in 2014, the CCP Central Discipline Inspection Commission announced three top officials' involvement in corrupt behaviors (*Legal Evening News [Fazhi Wanbao]* 2014, April 8). One year later, Xu Jianyi, the chairman and the CCP secretary of the FAW, also faced judicial action for corruption (Xinhua.com 2015, August

⁶⁹ The numbers in parenthesis show rank in the 2015 Fortune Global 500.

13). In sum, Chinese state capitalism succeeded in making selected SOEs into mega-enterprises, but these are still far from having an institutionalized and sustainable corporate governance structure.

The dissertation also has implications for our understanding of the relationship between the state and private firms in contemporary China. China's private entrepreneurs tend to be "allies of the state," rather than posing a threat to the incumbent authoritarian regime (Chen and Dickson 2008, 2010; Dickson 2003). The private entrepreneurs in China's auto industry are bound by two different level of constraints. In the auto industry, where the central state still holds rent-making power through its control of production licenses, private actors are gaining legitimate positions by becoming the entities that realize the original intentions of the AIP. The new players in the auto industry such as Geely, Chery, BYD, and Changcheng have performed much better at indigenous innovation than the firms in the dominant coalition. In a situation where the central state has control of the rules of the game, such as entry control, then private actors can hardly go against central policies. Their positions are too vulnerable to the central state's final approval. Hence, rather than resist rules set by the central government, private entrepreneurs compete fiercely for recognition within these rules. In addition, they have developed under local states' patronage. Due to the fierce competition among subprovincial local governments to "invite business and attract investments," private actors have gained much more leverage in negotiations with local governments than they once had. Nonetheless, as shown in Geely's Volvo merger, discussed in chapter 5, private companies cannot expand their business without financial support from local governments. As a result, private actors are tied to the central government to gain recognition as legitimate actors in the industry and they are financially dependent on local governments.

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