China: Authoritarian Capitalism

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Abstract

This chapter of *The Oxford Handbook of Asian Business Systems* provides an overview of the institutional structure of the business system of China. It explores the role of the state, the financial system, ownership and corporate governance, the internal structure of the firm (management), employment relations, education and skills formation, inter-company relations (networks), and social capital. Our analysis suggests a form of authoritarian capitalism, with the Communist Party retaining pervasive influence throughout the system. Within the basic architecture now in place, much institution-building remains to be done, with bottom-up, decentralized processes playing an important role in institutional change. Salient systemic characteristics include informality — deviance of actual practice from formal structures — and multiplexity — the presence of multiple business systems within China. This chapter contributes directly to the business systems and varieties of capitalism literature and identifies institutional contingencies for comparative and international social science research in general.

**Keywords:** China, Asia, business systems, varieties of capitalism, institutions, authoritarian capitalism, institutional change, informality, multiplexity
**Introduction**

By any measure, China has re-emerged as a major player in the world economy. By the latest reckoning, it now has the world’s second-largest GDP, whether measured at nominal or purchasing-power parity exchange rates; produces the world’s largest trade surplus; holds the world’s largest foreign-currency reserves; attracts less foreign investment only than the United States; and is now the world’s largest market for a range of products, including automobiles. While there is some discussion about the eventual end-point of China’s economic rise in terms of per capita GDP (Redding and Witt 2007), most observers consider it likely that the country will within the next decades overtake the United States in terms of overall GDP.

The shape of the Chinese business system is more set in its evolutionary trajectory than is commonly appreciated (cf. also Walter and Howie 2012). A widespread fallacy is to equate high economic growth with fast and especially discontinuous institutional change. While the Chinese business system is more in flux than those in most advanced industrialized economies, recent years have seen relatively limited institutional change, compared with the far-reaching adjustments between the start of economic reforms in 1978 and the early 2000s. Three decades of rapid economic growth, and relative stability in the face of the 2008 financial crisis, have given rise to confidence in Beijing and elsewhere that the Chinese business system may in many respects be at least equal, if not superior, to those of the advanced industrialized nations. Accordingly, China in recent years has produced more incremental than discontinuous institutional change, with an emphasis on adjustments to, and deepening of, the current institutional structure rather than changes to the basic architecture. On recent form, it appears likely to congeal as a modern form of state-dependent mercantilism, rather than a version of the free-market democratic capitalism that once appeared to have been ‘the end of history’ (Fukuyama 1992; Fingleton 2008). Whether such a configuration would be conducive to long-term economic performance is open to question.

Our business-systems analysis reveals a complex picture that suggests that much institution-building is still to be done within the basic architecture now in place. This is clearly evident in the provision of education and skills training, which does not yet match firms’ needs. It is also visible in the lack of institutionalized trust in the system, which in turn leads to high levels of centralization and low delegation inside firms. Deviance of actual practice from formal rules is common and especially salient in the financial system (formally bank-led, but not providing loans to most of the economy) and the employment relations area (formally tripartite, but in reality dominated by the Communist Party). Throughout the system, the influence of the Communist Party of China is pervasive (Malesky, Abrami and Zheng 2011).

**Context**

Like many large countries, China is home to multiple business systems. Firms with different types of ownership – state, private, or hybrid, as explained below – are subject to different rules of the game. Similarly, there are regional institutional variations. The presence of such diversity naturally complicates the task for this chapter. At the same time, the fundamental challenge is qualitatively identical to analysing, for instance, the United States, which has a mixture of publicly-listed, family-owned, and non-profit enterprises operating within institutional contexts that vary, at a minimum, by region. Guangzhou and Shanghai may be quite different, but so are Silicon Valley and Main Street.

Within the constraints of this chapter, we will reduce complexity by focusing on ownership patterns, which we see as the main dimension of variation. Specifically, we will contrast private and state-owned firms, with hybrid firms falling somewhere in between. We acknowledge the presence of geographic variations, though evidence suggests that their
impact may be diminishing over time (Witt and Lewin 2004). We can give spatial differences only limited treatment, specifically in the context of political and evolutionary dynamics.

**Role of the State**

Viewed from a Western perspective, China’s political system is unusual in that ultimate political power rests not with the government, but with a political party, the Communist Party of China (CPC). Government structure overall mirrors that of the CPC, with the same personnel often occupying equivalent positions in both organizations, so we will use the terms ‘CPC’ and ‘state’ interchangeably. While formally subject to the Constitution of the People’s Republic of China, the CPC is effectively above the law, and individual cadres often escape legal punishment for transgressions (though they may be sanctioned by the party). The main constraint on the CPC is the concern that it could fall from power if it loses popular legitimacy. Maintaining this legitimacy is seen to require the maintenance of a stable political order, which in turn implies a need to suppress open protest and improve material living conditions through economic growth.

Accordingly, China today is a developmental state with distinct predatory admixtures. The developmental objective is based not only on the desire of the CPC to remain in power, but also on a sense of historical humiliation and decline and an attendant desire to restore China to what is seen as its rightful place in the world. China in 1800 produced about one-third of world industrial output; by 1978, its share of world GDP was less than 1.8 percent (World Bank 2010), and China had become one of the world’s poorest societies. Economic reforms aimed at rectifying this situation began in 1978. A key component in these efforts was the gradual strengthening of market mechanisms (Naughton 1996) and material incentives for engaging in economic activities.

The developmental dimension of Chinese economic policy is visible in its adoption and adaptation of Japanese-inspired industrial policy (Nolan 2002). Targeted firms are in particular the presently 117 core state-owned enterprises (SOEs) (SASAC 2012) under the auspices of the central government State-Owned Assets Supervision and Administration Commission (SASAC), which comprises firms in industries considered essential and thus too important to be left to market forces alone, as well as firms intended to develop into world-competitive multinational enterprises (MNEs). Lower levels of government often have their own SASACs and industrial champions.

Industrial policy tools have included oversight and protection by government, the allocation of capital at subsidized rates, and export promotion. Unlike Japan, China has permitted foreign competition into the country through imports and inward foreign direct investment (IFDI), the latter providing a basis for learning best practices through joint ventures. Also unlike Japan, China has so far had limited success at coordinating technology diffusion and joint research and development involving competing firms. Arguably, the state facilitates diffusion of technology through relatively lax enforcement of intellectual property rights.

Predatory elements are visible in personal enrichment by party officials and their families and friends. Common manifestations include corruption and the illegal appropriation of communal land or state property for private benefit (Ong 2012). While senior leaders are generally perceived to be clean, their children, known as ‘princelings,’ and extended families tend to do remarkably well in business, presumably helped by their connections. For instance, relatives of Xi Jingping, likely to be the next CPC Chairman, allegedly have amassed a fortune exceeding US$700 million (Bloomberg 2012), and relatives of the disgraced Politburo member Bo Xilai, more than US$160 million (Barboza and LaFraniere 2012). While there is no evidence that these and similar fortunes were unfairly gained, they do represent a public-relations challenge for a party supposed to represent the interests of the
proletariat. Efforts to stomp out corruption have so far been only mildly successful.

China at first seems like a statist environment, with top-down decision-making. Corporatism-style tripartite structures exist, but as we will discuss later, these are under effective CPC control. While they do permit for some voice and accountability (Kennedy 2005; Malesky, Abrami and Zheng 2011), their consultative and participatory functions are limited compared with Western democratic corporatism.

However, China’s highly decentralized quasi-federalist structure facilitates the emergence of bottom-up economic policy initiatives (Cao, Qian, and Wringast 1999; Naughton 2007; Redding and Witt 2007; Carney, Shapiro, and Tang 2009). Counter to conventional wisdom, which sees the central government as all-powerful and fully in control, much policy-making and implementation is devolved to lower levels of government, including revenues and outlays (OECD 2005).¹ This decentralization is partially an inadvertent consequence of the country’s size, with more remote areas having historically enjoyed higher degrees of autonomy. It is also the result of deliberate policy intended to provide room for local competition and experimentation, so as to evolve information about the feasibility of specific institutional reforms for China’s transition towards a modern economy – hence Deng’s notion that China would develop by ‘groping for stones while crossing the river’. We will explore this aspect in more detail below.

Implementation of government policy as expressed in laws is relatively weak. While government effectiveness in 2010 was passable, at about the 60th percentile among all countries worldwide (par with Thailand, but far behind other Northeast Asian economies), the rule of law remained weak, at the 45th percentile (World Bank 2012b). Among the economies in this handbook, only Vietnam, the Philippines, and Laos performed worse on this measure. Part of the explanation for this was corruption, with China scoring 3.6 out of 10 (10=cleanest) in the 2011 Corruption Perception Index (Transparency International 2011). At the same time, the local experimentation already noted has by necessity involved breaches of existing laws, and local officials’ prospects for promotion depend much more on producing growth than on remaining within the law (Economist 2012; World Bank 2012a). Though laws may in due course be updated to reflect new realities, the implication is that there is usually divergence between published laws and actual practice.

The CPC remains highly interventionist. The Economic Freedom index score for China in 2011 was 51.2 out of 100, earning China a rank of 138 out of 179 countries, behind all other economies covered in this Handbook except Laos (50.0) (Heritage Foundation 2012). Likewise, the OECD (2012) found that Chinese product markets in 2008, the latest year for which data are available, were more heavily regulated than those of all OECD countries and the BRIICS², especially with respect to state control and barriers to entrepreneurship.

Financial System
China’s financial system, at first glance, is clearly bank-led, relying heavily on state-owned banks to provide access to finance. In 2010, 82.9 percent of corporate funds raised in the Chinese domestic market came from banks (Walter and Howie 2012). Corporate bonds accounted for 9.1 percent, and stock issues for the remainder (Walter and Howie 2012). This situation is unlikely to change much, as policy-makers see bank dominance as a means of maintaining control over the financial system (Naughton 2007).

Further exploration reveals a more complex picture. In particular, system

¹ One inadvertent consequence of this is that many local governments are indebted to a point that China could soon be facing a debt crisis of its own.
² BRICS and Indonesia
characteristics vary greatly, depending on whether a company needing access to finance is privately- or state-owned. Private businesses have had very limited access to official bank loans, not to mention capital markets (Tsai 2002; Rothman 2005; Herd, Piggot, and Hill 2010). The latest published statistics show that in 2009 loans to private enterprises and self-employed individuals were RMB711 billion, out of a total loan volume of RMB68.2 trillion (National Bureau of Statistics of China 2011) – in other words, 1.0 percent. Even if we assume that the number given only refers to short-term loans (the statistics are unclear on this), the private-sector loan share in that segment would amount to only about 4.9 percent (National Bureau of Statistics of China 2011). It is possible that the actual number is somewhat higher, as entrepreneurs have been known to find creative ways to pose as a state-owned business or may leverage political connections in order to obtain access to finance (Tsai 2002). Overall, however, private business is relatively starved of official capital, and its predominant mode of funding is savings, loans from family and friends, and unofficial financial operations, such as loan sharks and unlicensed banks (Tsai 2002; Rothman 2005; OECD 2010). Estimates put the volume of underground bank loans at about 30 percent of the total (Yao 2011). The unofficial benchmark rate for such loans, the so-called 'Wenzhou rate', is usually a multiple of the official lending rate. In spring 2011, it reached 6–8 percent per month (Economist 2011), implying that such finance is usually short-term.

By contrast, SOEs and well-connected firms tend to enjoy ready access to long-term finance. State-owned banks, including the China Development Bank and the China Export-Import Bank, represent their main source of funding, often at favourable interest rates and for the long term. For instance, Huawei, a well-connected leading producer of telecommunications equipment, disclosed in its 2010 Annual Report that it had annual borrowing costs below 1.7 percent for more than half of its outstanding loans, with some rates as low as 0.94 percent. Stock-market listings for these companies serve as a complementary source of external finance for these firms. Where such listings involve SOEs, the state often retains a controlling stake (Naughton 2007; Tian and Estrin 2008).

Ownership and Corporate Governance
Ownership is the key differentiator of domestic firms in China. In simplified terms, firms can be sorted into three buckets (Redding and Witt 2007): private, state-owned, and hybrid. Private firms are usually privately-held family businesses or partnerships. It is these firms that have been driving China’s high growth rates. In 2007, they accounted for 75 percent of all firms in China (cf. 1998: 24 percent), 50 percent of total employment (1998: 13 percent), 32 percent of fixed assets (1998: 10 percent), and 45 percent of value-added (1998: 15 percent) (OECD 2010).

Recent developments in the wake of the 2008 financial crisis suggest some efforts to pare back this private predominance, under the unofficial slogan ‘guo jin, min tui’ (‘the country/government moves in, the private sector retreats’). It remains unclear whether these efforts represent a new pattern or another ephemeral policy initiative; the most recent available systematic evidence on the private sector, where much of this experimentation happens, suggests continued vibrancy (OECD 2010).

Firms under state ownership come in various guises. The best-known type is the so-called state-owned enterprise (SOE). SOEs in industries considered strategic to China’s development and security tend to be fully state-held (Naughton 2007). Many other SOEs have been listed on stock exchanges inside and outside China. Though Chinese official statistics no longer classify them as SOEs, the state usually retains a direct or indirect controlling stake (Naughton 2007), and more than half of China’s listed firms in 2009 were ultimately state-owned (Yang, Chi, and Young 2011). In 2007, SOEs under direct or indirect state ownership accounted for 6 percent of all firms in China (1998: 38 percent), 22 percent
of total employment (1998: 62 percent), 47 percent of fixed assets (1998: 69 percent), and 31 percent of value added (1998: 55 percent) (OECD 2010). As these statistics suggest, SOEs tend to be considerably more capital-intensive than private firms.

The ‘state-owned’ category arguably also includes collective enterprises. These differ from SOEs mostly in terms of the government level that exerts control: Collectives are usually under the authority of a lower level of government, such as township or village, while SOEs are the domain of higher levels, such as provinces or central government. Collectives are by now virtually insignificant in the economy, with a share of less than 5 percent across measures (OECD 2010). We consequently exclude them from the discussion.

Hybrid firms are, as the name implies, in between. They often look and behave like private enterprises, but their ownership pattern may involve a considerable government stake. To complicate matters further, in official statistics they may be counted in either the state-owned or private sector, depending on their evolutionary trajectory. They are commonly referred to as ‘local corporates’, a term suggesting a local branch of state administration in alliance with indigenous entrepreneurs and possibly foreign investors, who may bring in technology and international market access. In our analysis, we consequently focus on private and state-owned firms, the two extremes between which hybrid firms will fall.

Important are further foreign private firms operating in China. These firms are both economically significant and, as conveyors of foreign expertise, an important source of social and technological innovation. They are usually hybrids combining some characteristics of their home countries with adaptation, successful or otherwise, to the Chinese environment. The need for adaptation is perhaps smallest in the financial sphere, as foreign firms may source capital at home or elsewhere. In other spheres of the political economy, however, pressures for local adaptation are stronger. For instance, even in the area most directly under control of the firm, internal structure, a long stream of studies in the field of international HR suggests a need for local adaptation of HR practices (Kostova 1999). Given their hybrid status, we will exclude these firms from analysis here.

Corporate governance in China is still weakly developed. In 2010, the Asian Corporate Governance Association (Gill, Allen, and Powell 2010) rated Chinese corporate governance 7th among eleven Asian countries, par with India and up from 9th place in 2007. Of various factors affecting the overall score, only its implementation of the International Generally Accepted Accounting Principles was close to world-class standards. By contrast, the report identified corporate governance culture and enforcement as the weakest links in the corporate governance system, scoring 30 and 36 out of 100 points, 50 and 44 points below the world-class benchmark.

Corporate governance in private-sector firms usually involves direct managerial control by their individual or family owners. There is considerable reluctance to separate ownership from control, mostly because owners do not trust professional managers to run the firm faithfully on their behalf. This mistrust is related to the lack of institutionalized trust in the business system, discussed later.

Given the role of the state as owner of SOEs as well as their primary source of funding, one might expect the state to keep close control over SOE activities and use of financial resources. In reality, this is not the case, because the Chinese state is everything but a unitary actor, as already explained. Similarly, banks do not enjoy much control over SOEs. They are not allowed to own stock and must extend many of their loans following government direction (Naughton 2007). In addition, the leaders of about half of the core SOEs outrank those of the major banks, with the former holding the rank of minister and the latter of vice minister (Walter and Howie 2012). As a result, the state-owned sector has neither a bank-based nor a market-based system of corporate governance. As Naughton (2007:320-1) summarizes,
To the extent that China has a control-based system [of governance], the control is fragmented among state-owned industrial holding companies, SASACs3 at various levels, and government and Communist party bodies. These agencies do not share consistent interests in firm performance or managerial incentives.

The result of this fragmentation is that managers of Chinese state firms are highly independent from markets, banks, and the state. Abuse of investors continues to be prevalent, especially with respect to minority shareholders, who possess neither strong legal protection nor much leverage over management through market mechanisms. For instance, some 70 percent of listed SOEs are reported to have built pyramidal structures, whose purpose is usually to enable the expropriation of investors through ‘tunnelling’, i.e. the clandestine transfer of assets from one organization to another (Carney 2012).

**Internal Structure of the Firm**

The available evidence on the internal structure of Chinese firms suggests that decision-making is in essence the exclusive prerogative of the very top of the pyramid. In prior research, Lieberthal and Lieberthal (2003) criticized Chinese firms for their weak integration and their tendency to be structured in silos, each with top-down control, and lacking in managers able to exercise integrating roles or envision entire value-chains. An autocratic tendency is evident in the finding that that human resource management, i.e. hiring, managing, and dismissing employees, is not being strategically devolved to line managers (Zhu et al. 2008). The same hierarchical sense pervades managerial ideology (Cheng, Chou, and Farh 2006; Kong 2006). Ideals of discipline, control and paternalism are key organizational norms (Kong, 2006), and managers tend to be reluctant to delegate to persons not personally trusted (cf. Chen, Peng, and Saparito 2002). These patterns are evident in both state-owned and privately-owned firms (Redding and Witt 2007).

Recent comparative evidence from the World Competitiveness Report (Schwab 2010) paints a consistent picture. Asked to report the extent of delegation within firms in their specific national contexts, executives from northern European countries report an average score of 5.31 out of 7, with 7 being highest. The score for Anglo-Saxon countries is 4.87, that for China, 3.60. The same basic pattern is visible in the choice between selecting senior executives on the basis of merit and qualifications or on the basis of friendship and family relationships. Here, the northern European countries report an average score of 5.83, Anglo-Saxon societies 5.95, and China 4.70. Connections and trust are thus considerably more important for gaining promotions in Chinese firms than in the West.

It seems unlikely that the situation will change much in the near future. First, the high labour turnover noted below is inimical especially to collaborative decision-making, as employees rarely have deep knowledge of, or much commitment to, the firm. Second, lack of institutionalized trust, as discussed below, hinders large-scale delegation as occurs in Western societies and Japan (Redding and Witt 2007). In particular, the absence of a reliable legal system means that it remains very difficult to hold others accountable if they abuse the trust implicit in delegation. Third, in SOEs, the custom of political state appointments for top managerial positions (Naughton 2007; Walter and Howie 2012), often from outside, virtually assures a disconnect between top management and the rest of the firm, both in terms of working relationships and of objectives.

In sum, the available evidence suggests that the internal structure of Chinese firms is relatively top-heavy and centralized, and that interdependence between managers and employees is generally weak. The implied stress on vertical discipline and control is unlikely

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3 State-owned Assets Supervision and Administration Commissions, agencies put in place at each level of government (centre, provinces, etc.) to oversee SOEs owned at that level of government.
to foster organizational competences in industries requiring extensive creativity or complex coordination.

**Employment Relations**

Formally, China has many trappings of northern European social democracies in this area. Industrial relations have been under a tripartite framework since 2001 (Lee, Sheldon, and Li 2011); the All-China Federation of Trade Unions (ACFTU) in 2008 had a union density of 48.3 percent and a collective bargaining coverage of 34.1 percent (Liu, Li, and Kim 2011); and employers organize in the China Enterprise Confederation (CEC), the All-China Federation of Industry and Commerce (ACFIC), and numerous local associations (Lee, Sheldon, and Li 2011).

The reality is more complex. For one, the tripartite process is highly fragmented among ‘10,702 tripartite bodies across national, provincial, municipal, county, district, and even street levels’ (Lee, Sheldon, and Li 2011:311). Second, the ACFTU is not really a union *qua* independent representative body of employee interests, but an organ of political control for the CPC (Taylor and Li 2007; OECD 2010; Liu, Li, and Kim 2011). This is logical if one considers that in a communist political system, there can be no independent unions, as the party already represents the interests of the proletariat. Accordingly, CPC endorsement is needed for new ACFTU initiatives, and the chair of the ACFTU is a member of the standing committee of the CPC and holds a government position senior to that of the head of the Ministry of Labor and Social Security (Taylor and Li 2007).

This has perverse implications in terms of interest representation, because in many cases CPC interests are closely aligned with those of business. Government owns many firms, and even where ownership is formally private, party officials often hold a personal stake. In addition, local government depends on tax receipts from local enterprises and income from their land use, and local cadres need good business performance and high investments if they want to be promoted. As a result, the ACFTU tends to fail to promote labour’s interests and shows a pattern of siding with management against striking workers (Taylor and Li 2007).

The situation on the employers’ side is more complicated (Kennedy 2005). A recent survey (Lee, Sheldon, and Li 2011) suggests broadly the following picture. The CEC and ACFIC are top-down, state-controlled associations. As such, they are the counterparts of the ACFTU, with CEC having stronger standing with SOEs, and ACFIC with private firms. One implication is that for SOEs, all three parties to the tripartite process are controlled by the CPC.

Private business does show some signs of independent representation, though its future direction is unclear. Until 2008, only the CEC was involved in industrial relations issues, and since its organizational structure did not extend much downwards, it left a vacuum in tripartite negotiations at lower levels of administration. Local employer associations arose to fill this opening, some of them under the control of local governments, but others apparently genuinely free to represent employers’ interests (see also Zhang 2007). With the entry of the ACFIC into the industrial-relations arena, a number of these local associations seem to have become affiliated with the ACFIC; only time will tell whether this signals a shift of the ACFIC toward civil society or the subordination of previously relatively free bottom-up employer associations under state control.

Employment protection shows a similar divergence between outward appearance and actual practice. *De jure*, following the tightening of labour regulations in 2007, China

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4. This makes perfect sense in a Marxist worldview, because workers opposing the interests of the party must obviously be confused.
features levels of employment protection that exceed those in the CMEs mentioned in Hall and Soskice (2001) (OECD 2010). De facto, however, employment protection is far less than de jure, with an enduring preponderance of fixed-term contracts involving few restrictions' (OECD 2010:153). This is consistent with survey responses contained in the Global Competitiveness Report 2010 (Schwab 2010) about the ease of hiring and firing. On a scale from 1 to 7 (1=impeded by regulations, 7=flexibly determined by employers), China scores 4.10, about the same as the UK. This compares with average scores of 3.81 for northern European countries and 4.25 for Anglo-Saxon countries (note that the average for the former is pulled up considerably by free employment regimes in Denmark, Switzerland, and Iceland; the median score for northern European societies is 3.20, that for Anglo-Saxon ones, 4.0).

Unsurprisingly, employment tenures tend to be short. Li and Sheldon (2011), for instance, found annual turnover levels of up to 30 percent. Smyth, Zhao, and Li (2009) present a case study with monthly (!) turnover rates of 10 percent, with one-third of the workforce actively looking for a different job and 40 percent ready to leave without hesitation.

Overall, while China from the outside looks like a European-style social democracy in this sphere, actual practice deviates considerably. In terms of interest representation, collective bargaining along northern European lines is impossible, foremost because there is no organization truly representing labour interests. In terms of employment protection, actual practice in China is in line with that in Anglo-Saxon countries. Given the vested interest party officials have in business, as already mentioned, it also seems unlikely that a true tripartite structure will emerge soon.

**Education and Skills Formation**

In exploring the Chinese education and skills formation system, it first bears emphasizing the relative weakness of the Chinese education system, despite many advances in recent years. UNDP publishes an education attainment index, which presents a composite score of literacy and school enrolment rates at all levels (UNDP 2009). In this, the lowest scorer among the countries considered in Hall and Soskice (2001) is Switzerland, with a score of 0.936 (out of 1 possible). China scores 0.851, par with Malaysia, just ahead of Suriname and just behind Lebanon. While the literacy rate in China was relatively high at 93.7 percent in 2008 (World Bank 2010), enrolment rates were still comparatively low, especially at the upper secondary and tertiary level (UNDP 2009).

In the economic context, China has faced a shortage of usable skills and a skills mismatch. Li and Sheldon (2011) reported that since 2002, demand for technical employees had exceeded supply. By 2009, demand-to-supply ratios had reached 1.43 at the most junior level, 2.24 for senior technicians, and 2.28 for senior engineers. The World Bank found that of 4.95 million students graduating in China in June 2007, 1.4 million were unfit for finding a job (World Bank 2007). Moreover, a 2005 McKinsey study found that of 1.6 million engineers in the Chinese labour market, only 160,000, about the same as in the UK, had the requisite skills to work at the level required in multinational corporations (Farrell and Grant 2005).

Part of the problem is that the build-up of the modern Chinese education system has emphasized general skills over vocational training (Li, Sheldon, and Sun 2011). From 1990–2008, enrolment in regular secondary schools grew from about 4.6 million to 80.5 million, a factor of 17.5, while the number of schools has fallen from 87,631 to 72,907 (Li, Sheldon, and Sun 2011). During the same period, enrolment in vocational secondary schools has increased only from 3 million to 7.7 million, a factor of 2.6, and the number of schools has fallen from 9,164 to 6,128 (Li, Sheldon, and Sun 2011). Not only are vocational training opportunities insufficient, educational contents are often mis-aligned with corporate needs, as
linkages between educational organizations and companies are generally absent (Li and Sheldon 2011).

In principle, companies could make up for this failure of the public education system through in-house training. In practice, the high levels of employee turnover already noted are a strong deterrent against this approach (Li and Sheldon 2011). Recent labour shortages have if anything increased the incentives for firms to poach from one another and for employees to follow the call of higher salaries. These conditions do not allow the emergence of a strong in-house training system.

It seems likely that at least part of these problems will persist into the foreseeable future. In particular, there seems to be a strong disinclination against vocational training for cultural reasons. Classical Chinese education tended to emphasize general intellectual skills, not unlike a liberal arts education in the West. By contrast, vocational training is associated with manual labour, which is not prestigious (Brabasch, Huang, and Lawson 2009). Even in Singapore, which is far more advanced in terms of GDP but retains many aspects of ‘Chinese’ ways of business, vocational training is seen as a sign of failure in school.

Overall, China’s education and training system is not yet up to the levels of the advanced industrialized nations. The education system that is in place leans toward general education, while skills training is weak.

Inter-Company Relations
The Chinese context features a high number of inter-firm alliances aiming at technology transfer in the shape of joint ventures (JV) between a local and a foreign firm. However, while such alliances tend to be voluntary in nature in advanced industrialized countries, in China they tend to be the result of legislation providing for market access in exchange for technology (Naughton 2007). Following the entry of China into the World Trade Organization in 2001, these requirements were successively relaxed. To the extent possible, new entrants have been forming wholly foreign-owned enterprises (WFOEs), and numerous JVs have undergone conversion to WFOEs (Puck, Holtbrügge, and Mohr 2009). In 2000, 53.3 percent of IFDI in China involved JVs, and 47.4 percent WFOEs; by 2009, the proportions were 20.9 percent and 74.8 percent, respectively (Walter and Howie 2012). As China further deregulates market access, JVs are likely to disappear almost completely as an entry mode.

Among domestic firms, there is limited need to form similar alliances for technology diffusion. China’s system of intellectual property protection suffers from weak enforcement (Keupp, Beckenbauer, and Gassman 2010), so Chinese firms are free to copy what they need. In addition, skilled workers freely move among competing companies, taking knowledge with them, and poaching is common (Li and Sheldon 2011).

A series of other forms of network exist, for various purposes. Business associations, as already discussed, seem to have evolved mostly in response to employment relations needs. Such associations, and also private ties among firms in the same industries, may also serve as a coordination device to help deflect price pressures from customers, especially those from abroad (Kennedy 2005; Lee, Sheldon, and Li 2011). Private ties with other managers and government officials have also been shown to affect firm performance (Peng and Luo 2000). At the same time, the depth of these networks does not appear to extend to areas such as standards and technology diffusion, which differentiates them from other Asian contexts such as Japan (Witt 2006).

Private-sector firms are frequently embedded in local production networks (Zeng and

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5 On the connection between culture and institutions in general, see Redding (2005) and Witt and Redding (2009); in China, see Redding and Witt (2007).
Williamson 2007). In these, a number of small firms collaborate in the production of a given product, similar to the pattern seen in European industrial districts (Whitley 1999). This form of collaboration can be highly efficient and effective; for instance, in the early 2000s, such networks, which are usually highly localized, accounted for 70 percent of the world market in cigarette lighters, 50 percent in shoes, 26 percent in toys, and 20 percent in neckties (Zeng and Williamson 2007).

SOEs and, to a much lesser extent, some private firms have also banded together to form business groups (qiye jituan). However, since most of these groups are actually dominated by a large SOE (Ma and Lu 2005; Keister 2009), including through ownership ties, these groups are perhaps best thought of as hierarchical conglomerates, rather than as networked business groups without a dominant member, as one would find them in Japan (Gerlach 1992).6 Earlier studies indicated that banding together in business groups, as expressed in interlocking directorates, improved performance and productivity in member firms (Keister 1998). On the other hand, more recent work has found that business-group membership has been declining in value (Carney, Shapiro, and Tang 2009), which may suggest that groups may disappear over time.

In summary, in terms of networking among firms, China is relatively well endowed, especially if we relax the definition of ‘social networks’ to include Chinese-style business groups.

Social Capital
Chinese society is noted for its reliance on interpersonal trust as expressed in instrumental personal ties (guanxi) (Walder 1986; Chan 2009). These ties usually extend to family members and friends, with trust diminishing with decreasing closeness as expressed in degree of family relationship and closeness of reciprocal friendship ties. Within the resultant concentric circles of trust, win-win cooperation is possible and common. Individuals outside these circles tend to be ignored or seen as rivals in a zero-sum competition.

Institutionalized trust is weak. The Civicus Civil Society Survey (Civicus 2006) identified trust levels in Chinese society as scoring 1 out of 3 (higher = more trust). Since this assessment includes the positive effect on trust of guanxi, actual levels of institutionalized trust are likely to be lower still. Similarly, results from the World Values Survey (2009) show that 89 percent of Chinese do not trust strangers. This mistrust is higher than in most of the advanced industrialized world; for example, the corresponding percentages were 49 percent for Canada, 74 percent for Germany, 7 31 percent for Sweden, and 60 percent for the United States. As a result, cooperation in business and elsewhere usually requires patient building of inter-personal trust.

The main avenue for building institutionalized trust in much of the West, especially the Anglo-Saxon economies, is a strong rule of law, which despite recent improvements remains elusive in China. Shortcomings in this respect include the lack of checks and balances in government, absence of legal accountability of the CPC and its organs and higher officials, CPC interference in court cases, a constitution whose provisions for individual rights are mostly honoured in the breach, and poor training and corruption of judges, prosecutors, and lawyers (Bertelsmann Stiftung 2009).

Similarly, civil society overall remains relatively weak. The Civicus Civil Society Survey (Civicus 2006) attested an average score of 1.40 for Chinese civil society (out of 3,

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6 Networks are customarily defined as ‘any collection of actors (N ≥ 2) that pursue repeated, enduring exchange relations with one another and, at the same time, lack a legitimate organizational authority to arbitrate and resolve disputes that may arise during the exchange’ (Podolny and Page 1998).

7 Distrust in Germany would presumably be lower if only residents of the former West Germany (i.e. without experience of Communist authoritarianism and subsequent system collapse) were polled.
higher=better), slightly ahead of Russia (1.23), but considerably behind the advanced industrialized nations for which the survey provided data (Germany: 2.35, Netherlands: 2.08, Northern Ireland: 2.1, Wales: 2.35). Key issues in the further development of Chinese civil society are a lack of funding and continued political control (Chan 2009). Ironically, the question of resources is related to the lack of institutionalized trust, as Chinese individuals have no confidence that civil society organizations will handle their money properly (Chan 2009).

**Institutional Complementarities**

The Chinese business system features a number of institutional complementarities, with important implications for comparative advantages of the Chinese economy. The main complementarities among the elements laid out earlier can be summarized as follows:

1. Bank-led finance and long-term availability of financial capital to SOEs based on government allocation are linked. Having bank-led finance does not in itself guarantee patient capital, but given state ownership and control, banks are a suitable tool for long-term capital provision. The same cannot be said of present-day financial markets, which tend to focus on the short term.

2. For SOEs, the combination of bank-led finance and majority or substantial state ownership is linked to weak corporate governance, as viewed from the perspective of minority shareholders. Since companies are not dependent on markets for financing, and state ownership effectively eliminates the threat of a hostile take-over, minority shareholders have little leverage on management.

3. For SOEs, the combination of weak corporate governance and long-term finance in principle should enable long-term employment by offering protection against shareholder demands to improve profitability through layoffs. This linkage fails, of course, in cases where the state decides to restructure the firm. It also seems to fail with respect to talented staff, who may leave voluntarily to enjoy higher pay in the private sector.

4. For private enterprises, government industrial policy targeting SOEs and the difficulty of obtaining official bank finance are linked. The financing needs of SOEs are such that the amounts available to the private sector are relatively small.

5. The relative lack of institutionalized trust is linked to the pervasive role of the state in the economy and attendant absence of the rule of law, as discussed.

6. Access to bank credit for private firms is further hindered by the lack of institutionalized trust. Even though they are part of the state apparatus, banks will be concerned that they will be unable to recover loans from private firms. While the same risk is in principle present for loans to SOEs, these are politically safe for banks as they extend these loans to other branches of the state apparatus, usually at the behest of other state agencies.

7. In the private sector, the lack of official bank finance and a more short-term view of finance are linked. The shadow banking system in China charges high interest rates to compensate for the risks associated with its activities. This makes unofficial bank loans a very expensive source of capital and provides a disincentive for relying on loans from these sources for the long term.

8. For private firms, state rules and practices preventing listings on the stock exchange are linked to a strong pattern of closely-held private ownership, often by families.

9. For private firms, family ownership and lack of institutionalized trust imply a tendency not to separate ownership and control. Instead, owners exert full managerial control.

10. For private firms, management by owners for the benefit of owners tends to be linked
to short-term employment. Neither owners nor employees see each other in a reciprocal collaborative relationship.

11. Short-term employment and a relatively poor skills training system combine to produce a skills shortage. There is no well-functioning public training system to equip workers with needed skills, and firms have a disincentive to train employees because the short time-horizon of employment makes it unlikely that investments on training can be recouped. This is likely to reduce the ability of the Chinese economy to compete in areas requiring high levels of labour skills.

12. For all firms, low institutionalized trust prevents delegation outside the concentric circles of confidantes. This in turn is inimical to participatory decision-making and thus reinforces the top-down nature of management processes. As a result, management and production processes requiring an ability to handle high levels of complexity are likely to be difficult to implement successfully.

13. Interpersonal trust and the inter-organizational networks in the business system, including production networks and business associations, are linked. Their relationship is in part endogenous, with personal contact at associations enabling the building of interpersonal trust, which in turn enables further cooperation in the association and possibly in business.

14. The CPC monopoly on the representation of workers prevents the evolution of a strong union movement representing the interests of workers, rather than those of the CPC and its corporate interests.

**Evolutionary Dynamics**

China’s evolutionary trajectory is remarkable in that it has undergone fundamental institutional reforms in the economy without attendant regime change, a feat that eluded the Eastern European countries in general and the Soviet Union in particular. Five factors in particular seem to be key in this context (Xu 2011). First, as already noted, the governance structure of China is highly decentralized, and regional leaders are effectively in control of economic policy within their territories. Second, the CPC retains tight control of the reins of power and of promotions and punishment within its ranks. China thus achieves the elusive benefits of simultaneous loose-tight properties. Third, party officials in the regions compete with their peers for rewards and promotion on their ability to meet a range of targets that prominently include economic performance. This gives lower-level officials an incentive to create and maintain an environment conducive to economic performance (though it also may induce officials to embellish statistics and for those whose performance is too weak for promotion to use their office to line their pockets).

Fourth, many regions in China resemble one another in terms of economic structure. One the one hand, this creates a very difficult environment for firms to generate profits, as many industries have large numbers of firms that are protected by local government and fight over a limited market. On the other hand, it has the effect of making the performance of officials in different parts of the country comparable, as conditions are roughly similar. And fifth, the exercise of political power is pragmatic in the sense that the contravention of existing formal institutions is tolerated as long as it serves the accepted ends and does not challenge or jeopardize the rule of the CPC.

In combination, these factors help reduce institutional inertia, at least with respect to the economy. The fragmentation of the institutional change process increases the difficulty for vested interests to prevent changes across the entire country. Competition facilitates diversity in experiments, which in turn evolves information about the feasibility of each solution and reduces the risk of instituting an unsuitable reform. China is, then, a vast laboratory full of experiments.
Among the drawbacks of this system is a high fragmentation of the rules of the game in Chinese business and attendant efficiency losses through increased transaction costs and competitive barriers. More importantly, however, it hinders the evolution of institutionalized trust by treating established institutions, including written laws, as expendable when expedient. In the long term, this is likely to have a detrimental impact on economic development prospects.

**Conclusion**

In summary, the Chinese state, dominated by the CPC, mixes developmental with predatory elements and remains highly interventionist. The Chinese financial system continues to be state-dominated, with funds flowing mostly to SOEs. Corporate governance of listed firms, especially the majority that are SOEs, seems to be weak, while private firms are usually directly controlled by their owners. Management style is top-down, with decision power concentrated at the very top. Employment relations look tripartite, but are dominated by state actors on three sides, so independent representation of interests is rare. The education system tends to produce general skills, and overall, the economy continues to suffer a skills shortage. Various forms of inter-company relations exist. Social capital is strong in terms of interpersonal trust, but institutionalized trust remains weak. The decentralized and competitive nature of institutional change renders the system resilient against deadlock, though at the expense of efficiency and institutionalized trust.

The very strong role of government is perhaps the most significant key to what may follow, and given the clear economic need for a vibrant entrepreneurial base, it is not beyond China, with its tradition of pragmatism, to forge an alloy that mixes the private drive to accumulate wealth with the legitimate public duty to preserve order. Chinese ideals have always contained those two strands, and arguably they will remain in effect beneath the continuing experimentation.

It is worth noting that the state's ownership of all land reinforces its power. There is no freehold in China, and the handicap this introduces to the progression of the economy at a future stage could be challenging, as it locks up much of the collateral that other societies have learned to permit their people to use (de Soto 2000). A similar restraint, tangentially related to the ownership of assets, and also crucial in other trajectories of economic progress, is the role of a bourgeoisie. For China, with its clearly vibrant private sector, it would appear at first glance that a strong bourgeoisie would be forming and might well exert the kind of 'reforming' pressure historically found in civil-society activism elsewhere. Several western forms of capitalism have evolved with the strong participation of this force, as it has carried both professionalism and self-regulation into many areas of economic life. In a comment on this process, Bergère (2007) points out that the Chinese state has kept docile the business people under its monopoly and has so arranged matters that in accepting entrepreneurs but refusing a bourgeoisie, it has created a system of capitalism without capitalists. Its mechanisms of producing this docility include two main interventions: the co-option of key players into the CPC as they emerge, and the persistent restraining of property rights.

Although in a classic mercantilist state, the government that drives the economic nationalism is pushed to do so by the business and industrial elite, it is feasible for China, without such overt business interests being exerted, to still adopt mercantilist practices in the interests of national re-assertion. Pride is very important to China, and its significance is enhanced by the history from which it is now escaping. It is also arguable that government interest in the Chinese economy remains high by both direct and indirect means, and that this removes the need for it to be pushed by a bourgeoisie seeking freedom to act. So, too, does the Chinese government know that its legitimacy remains based on its capacity to keep delivering not just order, but prosperity.
This assessment is of course not the final word. The Chinese economy is still far from the living standards prevalent in advanced industrialized countries, and its institutional structure, both formal and informal, is likely to require further refinement. As for any other economy, continued economic success will be contingent on the ability of the Chinese business system to meet three interrelated requirements (cf. Beinhocker 2005): innovativeness, adaptiveness, and efficiency. So far, just as Japan may be praised for innovativeness and efficiency, but criticized for weak adaptiveness, China may be praised for adaptiveness and efficiency, but criticized for weaknesses in innovation (Redding and Witt 2009).

Progress on all three dimensions is needed for China to become truly rich on a per capita basis. As we have already seen, further adaptability may be hamstrung by cultural factors and the presence of vested interests. Efficiency improvements will likely require the country to face core societal issues, including fostering individual initiative, creativity, and commitment, and, in parallel, building the quality of institutionalized trust to raise the density of economic exchange. This latter issue does not just relate to trade in goods and services, but also to trading cooperation in a boss–subordinate relationship. Most societies that have successfully trodden this path have done so in the context of the emergence of civil society and decentralization of political power, and eventually the emergence of individual voting rights over national issues. While it is possible that China will discover a new path toward the same end, it is still legitimate to wonder how it might face these universally applicable issues in its own way. Unless it does so successfully, it runs the risk of becoming stuck in what is known as the ‘middle-income trap,’ which denotes the difficulty of producing a per capita GDP higher than about USD16,000 (Redding and Witt 2007; Eichengreen, Park, and Shin 2011). Given current growth rates, the moment of truth is likely to arrive around 2020.

Untested as yet is also the ability of modern China to produce world-class innovativeness. Evidence to date suggests that innovation will remain a serious point of weakness that can only be counterbalanced by continued technical borrowing. There are several immediate sources of that weakness, including inadequate legal infrastructure, which relates to institutionalized trust and the property rights it implies; organizational traditions of autocracy and tight control that stifle close manager–worker interdependence; scale limitations in small enterprise that stem from mistrust; and limited availability of venture capital (Kenney, Haemmig, and Goe 2008; Redding and Witt 2009).

Turning to the implications of this chapter for the conceptual development of the varieties of capitalism literature, two aspects stand out. First, unlike in most of the advanced industrialized countries studied in the literature, formal structure and actual practice in China diverge fundamentally. This is logical if one considers the reliance of the Chinese political economy on local experimentation and thus local variation in institutions, much of it in contravention of existing national laws and thus running counter to the formal coordinating structure. To the extent this evolutionary mechanism remains in place, as it is likely to, efforts to make sense of China on the basis of formal institutions are likely to reach conclusions of limited validity. Second, our analysis raises the question of how to accommodate the possibility of multiple varieties of capitalism within the same national boundaries. At least in some spheres, private and state-owned Chinese firms play by different rules of the game. One possible interpretation is that this phenomenon is a temporary artefact of China’s transition from central planning to a market orientation. The shrinking of the state-owned sector as well as the emergence of a hybrid sector amalgamating elements of both can be interpreted as a harbinger of eventual convergence on a single model (though this may be so far off in time as to raise the question of when a transitory state stops being transitory). However, there is also the possibility that private and state-owned firms may represent two distinct sustainable
punctuated equilibriums. In this view, hybrid firms may either be a third equilibrium in-between the others (Redding and Witt 2007), or just the tails of the statistical distributions centred on these equilibriums.
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