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The Role of the State in Making a Market Economy

by

VICTOR NEE*

This paper highlights the crucial role of the state in establishing a market economy, through an analysis of the early stages of market-oriented reforms in China. China followed an evolutionary approach to economic reform that has relied on the preexisting state to oversee the construction of a market economy. Trial-and-error problem solving in the formative stages of market transition led the central state inexorably to oversee institutional changes to establish a modern legal-rational bureaucracy. Although the state remains structurally vulnerable to rent seeking, it gained the organizational capacity to institute and enforce rules critical to the emergence of a hybrid market economy. (JEL: H 1, P 0)

1. Introduction

The Chinese state has presided over a decisive shift to a mixed economy in which market-driven economic growth has been both rapid and sustained. The success of the Chinese market reform under a socialist state, when contrasted with the experiences of the former Soviet Union, highlights the need to reexamine the role of the state in establishing the institutional framework of a market economy. Chinese reformers employed the preexisting state to build, by trial-and-error, a market economy. In contrast to China, Russia's market transition followed a big-bang approach in which the state simultaneously sought to remake Russia's political and economic institutions. The Chinese state has orchestrated a remarkable two-decades of market-driven economic growth, whereas Russia's post-socialist state appears incapable of governing a market economy. How did the Chinese state make a market economy?

A considerable body of scholarship documents how the Chinese state has sought to manage economic growth through nonmarket means during the Maoist era. Although these studies differ in their assessments of the effectiveness of bureaucratic allocation, they share a common assumption that state socialism is largely hostile to the allocative role of markets. Before the current market reforms, there was little reason to question this view since state interventions in any case had the

* This article is a revised version of a chapter published in NEE AND STARK [1989].

effect of restricting and limiting market forces. Yet, not only were market reforms initiated by the Chinese socialist state, but subsequent expansion and consolidation of market forces required selective state interventions.¹

The transition to a market society requires continuous state interventions to establish the constitutional framework, in the sense of the underlying rules of the game, and to demonstrate a commitment and capacity to enforce them. In the rise of the market economy in the West, "the road to the free market was opened and kept open by an enormous increase in continuous, centrally organized, and controlled interventionism," argued Karl Polanyi. "Administrators had to be constantly on the watch to ensure the free workings of the system" (POLANYI [1944, 140]). In Polanyi's view the unregulated market threatened to destroy society, and efforts to protect society from its ravages necessitated sustained regulatory interventions by the liberal state, in the process of which the state incrementally constructed the institutional framework of the free market. According to him, "free markets could never have come into being merely by allowing things to take their course" (p. 139). Douglass NORTH [1981], building on Polanyi, emphasizes the reduction of transaction costs resulting from regulatory interventions. The establishment of a federal agency to regulate the American meat industry, for example, promoted the export of meat in world markets by reducing uncertainties about the quality of American meats. In state socialism the impulse to regulate private markets has been much stronger and more restrictive than in market economies. Indeed, in the period following the revolutionary takeover of power, the state intervened in the economy to bring markets firmly under state control with the longterm objective of eliminating free markets altogether. China in the Great Leap Forward and Cultural Revolution almost succeeded in accomplishing this goal. By contrast to the Maoist period, since 1978 a new regulatory approach allows firms and entrepreneurs considerable autonomy. It attempts to regulate indirectly through manipulation of prices and therefore relative profitability, as opposed to directly through state interventions specifying particular courses of action. The intent to use indirect macroeconomic controls and microeconomic regulation is explicit in many Chinese policy statements since the start of market reforms.²

This paper analyzes the intertwined processes involved in the construction of a rational, end-oriented bureaucracy with societal autonomy and the establishment by the state of the formal institutions buttressing a mixed economy, including commercial laws that specify a new structure of property rights, mechanisms to enforce

¹ Although market reform has weakened state controls over the economy, the Chinese state continues to be a dominant organizational force in the economy, specifying the institutional parameters of production and exchange oriented to the marketplace. Should the state ever again become committed to restricting rural markets, it has powerful means at its disposal to accomplish this goal. In the rural economy, for example, the state controls many basic factors of production such as land and access to modern inputs, maintains production quotas, and sets the purchasing price for key agricultural commodities.

² The current approach may well have been contemplated during the 1950s or early 1960s, but certainly not during the Great Leap Forward and after 1965.

contracts, and new market structures. I examine the early stages of market-oriented reform, which began in rural China, to trace the specific forms of interventions initiated by the state to institute a market economy. Though at the risk of merging distinct issues, I argue that the emergence of a legal-rational bureaucracy and a market economy are causally linked. They result from the state's interest in promoting economic growth through market reforms and its attempts to lower the high transaction costs involved in integrating an emergent market economy within a state-dominated economy. Simultaneous with the state's effort in setting up institutions of a market economy are its efforts to reform the economic institutions of the still dominant state sector. To accomplish this, the dynamics of market reform in China have pushed the central state toward increasing bureaucratic rationalization and societal autonomy.

2. Making a Market and the Organizational Boundaries of the State

In instituting market reforms, paradoxically the Chinese socialist state was often the midwife of emergent market institutions. When it launched market reform, it needed to legitimate reform policies among the agents of the state and to intervene to create the institutional framework of a mixed economy in which the market assumes a greater role in economic coordination. Fundamentally this effort required the state to specify and enforce a new structure of property rights and to lower the transaction costs associated with integrating market and bureaucratic mechanisms of coordination in a mixed economy. High transaction costs are reflected in the windfall profits of political actors and middleman entrepreneurs who broker lucrative transactions between the state and market sectors of the transition economy.

After decades of state allocation of resources, a return to a market economy entailed major institutional changes. First, reformers must gain the support and compliance of the state bureaucracy in the legitimization of reform measures. Because the state was the primary organizational actor in initiating market reform, the voluntary compliance of middle- and lower-level state officials and functionaries was necessary for the successful implementation of reform policies. Second, new market structures needed to be established and old markets expanded and modernized. New legal codes to regulate enterprises and market transactions needed to be instituted and enforced. The legitimate uses of public property and resources needed to be specified and enforced. More important, private property and the profits of business need to be safeguarded in communities where only recently the pursuit of profit was a political and social taboo. In short, the institutional framework buttressing markets have to be renewed, constructed, and legitimized by the state. Moreover, with regard to reform policies it is politically more important to achieve legitimization and compliance among political actors than among economic actors in society.

The capacity of the state to intervene in society to institute a market economy is affected by its degree of societal autonomy. The state's ability to intervene in sup-

port of long-term policy goals is weakened when either latent or manifest opposition to the policy emanates from social groups that have access to state power. The boundaries of state organizations vary in their degrees of permeability, at varying levels of societal interactions, and in different sectors. As with other social boundaries, processes similar to osmosis regulate the flow of exchanges (including people) between state and society (BARTH [1969]). Organizational boundaries are porous or *open* when state organizations are embedded in society through the existence of social networks that knit the state to society, whether they are “old-boy” networks linking officials to dominant classes or patron-client ties linking the state to subordinate social groups. Clientelist politics entail open organizational boundaries insofar as political actors in the state build support for their policies through mobilizing patron-client networks. The more open the organizational boundaries of state structures, the more susceptible are states to societal claims and the less bureaucratic they are in Max Weber’s sense of a modern bureaucracy.

Organizational boundaries are spoken of as *closed* when state organizations are relatively unencumbered by exchange networks linking political actors with social groups, either of the dominant class or of subordinate groups. Open organizational boundaries are associated with lower organizational capability for autonomous action because they are more susceptible to claims or liens made on the state by social groups. The relative openness of organizational boundaries does not mean that the state is more open to a broader base of participation, more equal in access to services or resources, or more responsive to the public interest. On the contrary, state organizations with open boundaries may be vulnerable to special interest groups, inaccessible to subordinate social groups, and unresponsive to the public interest (OLSON [1982]). Nor do more open organizational boundaries imply that the state is less selective or more inclusive in its recruitment procedure for officials and staff. A development state, with open organizational boundaries, may limit recruitment on strict ideological and class criteria, as in the Maoist era. Moreover, open organizational boundaries may be associated with more internal closure if the state is controlled by an oligarchical elite. Relatively closed boundaries, on the other hand, may at times result in more openness within, in the conduct of day-to-day business and in the recruitment and retention of members. Achieving the right balance between embeddedness and autonomy is crucial to success in promoting economic growth (EVANS [1995]).

The relative openness of the organizational boundaries of the agrarian bureaucracy was an unintended by-product of the Chinese revolutionary experience. The Chinese Communist Party won state power through its ability to mobilize the peasantry by building a permanent organizational presence in villages. This made possible sustained mobilization extending from the Sino-Japanese War, through the civil war and revolutionary land reform, to the collectivization of agriculture and the creation of the people’s commune. “By creating a Communist Party and by training a new type of leader, the cadre, the Chinese Communists were finally able to achieve what no state power in Chinese history had been able to do: to create an organization loyal to the state which was also solidly embedded in the natural vil-

lage.” (SCHURMANN [1964, 416]). The mobilizational politics of the Chinese communist state required local political actors who were subject to the state’s organizational control and natural leaders in the village community capable of mobilizing peasants to support and comply with state policies. In the Maoist era, cadres acted within a moral order molded by local customs and conventions, but they remained in power with the approval of the local state and were the embodiment of the state in the village society (SCHURMANN [1964] and SHUE [1979]). Local cadres lacking popular support in the village faced difficulty in exercising the power their government positions granted them.

Complex and often subtle exchanges between villages and commune and county governments, mediated by village cadres, both facilitated the implementation of state policies and provided the village with access to state-controlled resources. The exchange of material resources and services typically involved exchange networks within the village and personal connections with officials in local governments in which village cadres played a pivotal role. Village cadres sought to build personal networks within the local government, as Richard MADSEN [1984] observed: “Longyong spent much of his time going to the commune and county seats making friends and securing ‘connections’ – exactly the type of corruption that he righteously abhorred within his village – in order to get priority for the village in the allocation of scarce building resources: cement for new grain-drying yards, lumber and nails for new buildings.” (p. 53). Jean Oi’s [1989] study of state and village relations documents the importance of clientelist ties in the distribution of a wide array of resources and hence in maintaining clientelist politics.

When Maoist mobilizational politics, the increasing allocative role of the state, and the decentralization of administrative power came together, as they did in the Great Leap Forward and the Cultural Revolution, local political actors gained considerable discretionary powers. As long as local cadres appeared to support the policies of the state, they could use their position to accumulate social and political capital by building and extending their networks in both local society and the state organization. As the state expanded its control over social and economic life, and as markets were replaced by the allocative role of the state, vertical personal connections assumed greater importance. Stable, ongoing personal relationships lubricated economic transactions involving multi-level bureaucratic hierarchies. For these reasons, economic transactions in state socialist redistributive economies became embedded in trellis-like clientelist networks that paralleled the vertical integration of economic units within the state-controlled hierarchy of organizations (WALDER [1986]). The Maoist bureaucracy thereby fostered an organizational culture that emphasized personal connections and the interpenetration of state and society by personal ties (*guanxi*). Yet, the more open organizational boundaries of state structures, the more susceptible are states to societal claims. The capability of the state to intervene to promote institutional change weakens when either latent or manifest opposition to its policies emanates from social groups that have access to state power.

3. *Crisis of Legitimacy and State Ideological Intervention*

The rapidity with which the Chinese state implemented its reform measures was startling in light of the decades of institutional investment in stabilizing and consolidating collectivized agriculture. From 1978 to 1981, there was experimentation with various models that tinkered with the collectivist organization form, but none of these proved satisfactory.³ By 1983, the collectivist organizational forms were displaced by a variety of household production models. The pace of change did not slow down. Market reform encouraged households to produce for the market rather than for the state once they met their contracted state production quota. Many households began to specialize in a single cash crop, but increasingly they also left agricultural production altogether to specialize in nonagricultural commodity production. A great number and variety of rural enterprises quickly sprang up, including private joint-stock ventures that pooled capital and labor. Peasant enthusiasm for the state-initiated reform was expressed in the virtual explosion of market activity and in the diversity of new organizational forms. The state's response to the resurgence of private entrepreneurship was to encourage and legitimize new organizational forms that conformed to its reform program.

In a rural economy in which marketing had atrophied during the decade of agrarian radicalism in the Cultural Revolution, the upsurge of so much new private entrepreneurial activity in a brief span of years gave rise to widespread uncertainty and confusion. Before the market reform, such activities were regarded as illegitimate and illegal. Hence, the creation of a public ideology supporting private entrepreneurship and the pursuit of profit is an especially important form of state intervention. Numerous accounts were published in the Chinese press documenting the lack of a normative framework that supported the new market-oriented behavior. As reflected in informal political discourse, cadres and peasants were unsure whether to classify entrepreneurial households as socialist or capitalist. A common saying among peasants was that "some people have gone too far in getting rich." In Hebei, one entrepreneur was reported to have earned 32,000 yuan in 1983. Villagers envied his success, noting that the earnings were several times greater than those of the landlords of the past. Some commented, however, that he should not be congratulated for his new-found fortune because his wealth probably would be liquidated in the future (*Renmin Ribao*, January 16, 1984, p. 2, April 16, 1984, p. 2). Merchants were vulnerable to the criticism that they were immoral in profiting from others' efforts without producing anything themselves (*Fujian Ribao*, February 14, 1984, p. 1). Another common characterization of the new entrepreneur held that, "[i]f a person gets rich,

³ I was doing field research in China during this early period of experimentation in 1980, and remember many mornings when peasants stood outside their front doors, listless and confused about the reform measures then under experimentation in Yangbei Village. The array of measures introduced in the village all sought to retain the basic framework of the production team, while approaching as closely as possible the conditions of individual household production. The new systems of accounting and remuneration were so complex and subtle that even the team accountant had difficulty in explaining them to me.

there must have been something he did that was underhanded." According to one report, widely held negative stereotypes led entrepreneurs to feel that they were victims of "discrimination, sarcasm, and even attack." These stereotypes characterized entrepreneurs as "complex or mixed elements," "shady character," "people who engaged in crooked ways and dishonest practices, in gambling and speculation, and in making ill-gotten gains" (*Renmin Ribao*, January 16, 1984, p. 2).

The rapid rise of entrepreneurs as a new economic force engaged in profit-seeking in the marketplace preceded the state's legitimization of private entrepreneurship. Lacking legitimacy, entrepreneurs were easy targets for hostility and suspicion directed against them by local cadres and fellow villagers. Their vulnerability left newly affluent entrepreneurs exposed and insecure about their status in the community. Reflecting this sentiment, an entrepreneur confided: "People in the village talk a lot about me, and I have a heavy mental burden. Some people have even said that specialized households will be repudiated. I am a little afraid" ("China", *Foreign Broadcast Information Service*, February 6, 1984, p. 3). Entrepreneurs worried that they might be attacked by jealous neighbors in a future political campaign.

The lack of a normative framework to support entrepreneurship also fueled widespread speculations about a possible reversal of state policy. Entrepreneurs wondered whether, as in past periods of liberalization, market-oriented policies adhered to in times of economic difficulty would be abandoned when the economy improved. Such uncertainty worked to erode the confidence necessary to make investments. The risk of losing one's investment appeared very high to many, as reflected in the following statement: "My family has made considerable investments on contracted land and we harvested nearly 20,000 jin of grain last year. But we always fear that some day the policy will be changed, and the land will be taken away from us, and our efforts will be wasted" ("China", *Foreign Broadcast Information Service*, February 8 and 24, 1984, p. 2). This perception encouraged the pursuit of short-term profits, often in fly-by-night or speculative ventures, rather than promoting the long-term investments that the state sought to encourage.

To counter the social criticism and negative stereotypes of entrepreneurs, the state mounted a major propaganda campaign to encourage entrepreneurs. The campaign to demonstrate official approval for private entrepreneurship lasted for several years and filled the national, provincial, and local media with upbeat images of the new entrepreneur. Typical of the tone of the state's effort to provide ideological support for entrepreneurship is the following editorial:

"It is only natural that they [entrepreneurs] have become rich first on the strength of their superior features of being adept in technology and in business dealings ... It must be admitted that in the countryside today ... it is hardly sufficient in doing things to rely sheerly on arduous and hard work, or on exertion of manual labor, or on taking advantage of traditional methods and old experiences ... [Instead] the ability to study and learn scientific knowledge and technical know-how, to be adept in absorbing various kinds of information and intelligence, to improve business management methods, and to dare to try out new ventures without fear of bearing the risks involved [are necessary for success]. Only the sum total of all these capabilities provides the main road for the new type of peasants to become rich in the 1980s." (*Banyuetan*, December 25, 1984, pp. 5f.)

The slogan “to be rich is glorious” permeated the Chinese media in news accounts that described in glowing terms the success of entrepreneurs who developed new products and firms, in documentary films highlighting the visits of high-level state cadres to bestow social honor on successful entrepreneurs, and in television features that projected an image of entrepreneurs as modern, enterprising, and efficient. The conferring of social respectability on private entrepreneurship was pursued with single-minded tenacity by the state’s propaganda machine. It helped to create a new climate of legitimacy for the market activities of new entrepreneurs among cadres, the primary readership of party-controlled newspapers.

In promoting market reforms, reformers sought to create an environment favorable to the development of entrepreneurship in rural communities. Not only did the state seek to extend credit to aspiring entrepreneurs, but it worked hard to persuade peasants that the new market-oriented policies were genuine in encouraging them to enrich themselves through their entrepreneurial activities. The state sought to assure peasants that their properties and profits were not at risk as they had been in the past because the new policies represented stable, long-term commitments by the state. Safeguards also were provided for private investments in public property, especially in arable land. In the early phase of decollectivization, households were assigned land only on a short-term basis. But because peasants were reluctant to invest in land that might later be taken from them to be reassigned to their neighbors, the contracts awarded to households to farm a plot of land were extended to two to three years. Even this extension proved too short, and eventually, the period of land assignment was extended to fifteen years. In many provinces peasants secured the right to inherit rights to land. The state furthermore stipulated that households were to be compensated for investments and improvements they made on their land in the event it was taken from them and reassigned to another household (*Renmin Ribao*, July 25, 1983, p. 2).

4. *Local Cadre Opposition and Malfeasance*

As enterprising peasants rushed in to take advantage of new market opportunities, they also encroached on the power of local cadres. Although some came from cadre backgrounds, most entrepreneurs who ventured into nonagricultural commodity production did not. Competition between local cadres and entrepreneurs set the stage for new lines of social cleavage and conflict in rural communities. In my 1985 rural survey, I interviewed village cadres who complained that there was a widening gap between their own earnings and those of their entrepreneurial neighbors.⁴ Indirect evidence of a decline in the status and prestige of village-level

⁴ Indeed, the sharp increases in reports of malfeasance among cadres can be interpreted as an indicator that as a group, cadres were falling behind economically relative to the new rich peasant elite, and sought to compensate the relative decline in economic status through illicit means. See MERTON [1949] for a discussion of relative deprivation as a mechanism fueling social conflict.

cadres can be found in reports of violence committed against them that went unpunished. For example, the *Hubei Daily* reported several instances of violence against a village party secretary, which left him with a brain concussion and injury to his right cornea, and an attack on a party member in another village that resulted in facial disfigurement and loss of memory owing to a brain concussion. The letter to the editor urged protection of lower-level cadres: "Both Chen and Deng were injured while on duty. In the first case, the injured man has not been able to pay his medical bill. And his assailant does not feel sorry and has not been punished. In the latter case, the victim was compensated for only half his loss. Though arrested, the attacker was released as not guilty." (*Hubei Daily*, July 2, 1985, p. 1).

In a state-dominated economy, the embeddedness of economic action in cadre networks limits the effectiveness of state interventions to promote market reforms in the early stages. Local cadre opposition to decollectivization was initially widespread; in some areas county governments were compelled to use coercive measures to force brigade and team cadres to decollectivize. Why were local cadres apt to oppose decollectivization? Firstly, in collectivized agriculture local cadres control the allocation of resources and manpower in the village. Under household production, allocative power is shared by the market and the state, and peasant households take control of agricultural production into their own hands. Decollectivization thus weakened the organizational basis of local cadre power. Secondly, as the functional roles of local cadres were reduced through decollectivization, their social power was also threatened. Peasant complained about having to support local cadres, their lifestyles, and their leisure, viewing them as "free riders" (POPKIN [1988]).

Although decollectivization initially weakened the organizational base of cadre power, local cadres still retained their middleman role, mediating exchanges between state and society, which in turn, helped to prop up their social power in the community (OI [1989]). Even though the village government was no longer responsible for managing agricultural production, cadres retained control over the allocation of land, rural industry, and other remaining collective assets, decided on the allocation of state production contracts, and collected taxes and other fees. Thus despite decollectivization, village cadres retained considerable power. Their power to issue licenses, and negotiate contracts for the lease of collective property and enterprises continue to give cadres the final say as to which households in the village will have the opportunity to develop the major productive assets of the village for private gain. Their control over rural industry provided a new basis of power as this sector grew rapidly in the reform era (OI [1992], NEE [1992]). This and their power to negotiate the terms of the leases and contracts have redistributive implications within the village.

To illustrate the continuing power of local cadres, I cite the case of Zhejiang province, where four households contracted with a brigade to grow peaches for three years, and agreed to pay the brigade 5,200 yuan for the right to manage the brigade's peach orchard. In the first year of the contract, the four households ful-

filled their contract and derived a handsome profit of 2,000 yuan per household. Their profit, however, incurred the jealousy of cadres and neighbors, who argued that it was gained at the cost of the brigade. The brigade cadres contended that they had set the contract fee too low and subsequently withheld the profits. The four households then brought the case to the county court for arbitration. The court ordered the brigade to hand over the profits to the four households. Shortly after the arbitration, the brigade abruptly terminated the contract with the four households and transferred it to another group of households (*Renmin Ribao*, April 21, 1983, p. 2). In another case, peasants were unable to meet their quota due to natural disasters in the area. Local cadres forced them to compensate for their quotas and debts by handing over their houses, cattle, pigs, carts, sewing machines, and grain. They also threatened to take away land assigned to households that refused to comply with their requisitions ("China", *Foreign Broadcast Information Service*, March 12, 1984, p. 1).

Simultaneous with the state's effort to encourage private entrepreneurship, frequent reports of local cadre hostility and abuse of entrepreneurs appeared in the Chinese press. The number and frequency of these reports, published in the official media read primarily by cadres, indicated that the problem was widespread. In general, the reports of cadre opposition to reform policies were most frequent in the early stages of market reforms, when many cadres opposed decollectivization. But once it became clear that the reform policies were being backed tenaciously by the national leadership, many local cadres sought to use their power and access to public resources to secure private benefits from market reforms. Thus media reports of opportunism and malfeasance among cadres grew dramatically and outnumbered reports of their opposition to market reform. But whether it was opposition or malfeasance, both were interpreted by the state as detrimental to the successful implementation of its reform policies.

There were many reports describing how cadres squeezed entrepreneurs by imposing unauthorized local taxes and levies (*Renmin Ribao*, May 14, 1983, p. 2 and *Banyuetan*, June 25, 1985, p. 1). In Jiangsu province, rural cadres imposed extraordinary levies on entrepreneurs, forcing them to pay for the repair of the brigade's truck, for a new local water conservation project, and for banquets held by the brigade cadres. Numerous accounts described how local cadres dropped by the homes and shops of entrepreneurs for free meals and banquets (*Renmin Ribao*, October 16, 1983, p. 2, May 14, 1983, p. 2, February 3, 1983, p. 4, and May 14, 1983, p. 2). There were other stories describing how local cadres used their power to wrangle from entrepreneurs partial ownership of new firms (*Renmin Ribao*, April 15, 1983, p. 2, and July 17, 1984, p. 5); to withhold profits made by households that sold their produce to the state so as to augment their own salaries; to take from peasants a portion of their crops over and above what was stipulated by their contracted quota; to threaten to cancel arbitrarily leases and contracts entrepreneurs held to public land or properties; and to rake off huge profits by playing a middleman role in the sale of commodities produced by peasant households ("China", *Foreign Broadcast Information Service*, March 1, 1984,

p. 3, August 8, 1985, p. 13, March 12, 1984, p. 1; *Renmin Ribao*, May 28, 1983, p. 2).

Not only did local cadres use their power to squeeze entrepreneurs, but there were many reports of cadre-led social conflict directed against entrepreneurial households. A typical account described how, in Hubei, the administrative village (*xiang*) and district (*chu*) cadres forced their way into a private restaurant, smashed the furniture and dishes, and forced the restaurant to close after they learned that the restaurateur had filed complaints that he had lost 1,500 yuan from forced requisitions for free meals by local cadres (*Renmin Ribao*, September 6, 1984, p. 2). The vulnerability of entrepreneurs to the power of local cadres was aggravated by jealous neighbors in the village community. Some reports described how jealous neighbors stole the entrepreneurs' crops, vandalized their property, and slaughtered their animals under cover of night (*Renmin Ribao*, April 15, 1984, p. 2; "China", *Foreign Broadcast Information Service*, April 18, 1984, p. 2). In Gansu province, a peasant who opened a bran mill discovered one day that her electricity had been cut off by village cadres. She complained to higher-level authorities. Her story of harassment was picked up by the provincial newspaper. Angered by the expose, the cadres threatened to retaliate, but she persisted in expanding her business. One day, the brigade's electricity was shut off by the county power plant due to the brigade's negligence in paying the village electric bill. The incident triggered a minor riot in the village when the village cadres led a hostile mob to cut the household's power line, forcing the entrepreneur out of business (*Renmin Ribao*, April 24, 1984, p. 2). The outcome of such harassment was to socially isolate and intimidate entrepreneurs (*Renmin Ribao*, September 22, 1983, p. 5; April 24, 1984, p. 2, March 20, 1984, p. 2, and June 9, 1984, p. 2). At the very least, the mere threat of mobilizing jealous and suspicious neighbors against them perpetuated a climate of worry and insecurity among entrepreneurs.

Though local cadres were hostile towards the emergence of autonomous economic power, they did not shrink from using their political power to profit from new economic opportunities (NEE AND LIAN [1994]). Some local cadres used their power to transfer a disproportionate share of the arable land to their own households (*Shaanxi Ribao*, September 23, 1983, p. 1, "China", *Foreign Broadcast Information Service*, October 14, 1983, p. 1). In Jiangsu province, local cadres were reported to have forced peasants to contribute free labor to farm their fields and to have used the brigade's fertilizer without paying for it (*Renmin Ribao*, July 17, 1984, p. 5). Cadres also used their power to obtain business licenses for their friends and relatives, ignoring the applications of others. They engaged in illegal speculation by using their power to purchase commodities from the state marketing agency to sell locally at marked-up prices ("China", *Foreign Broadcast Information Service*, January 27, 1984, p. 3). They have also tried to profit by selling products to state purchasing agencies at marked-up prices. For example, in Jiangsu province, a commune party secretary sold 5,000 pairs of gloves to the commune for 75 cents each, which his family business produced at a cost of 30 cents each, even though there was little market demand for these gloves (*Renmin Ribao*, July 17, 1984, p. 5).

In describing these instances of cadre opposition and malfeasance, I do not deny that many local cadres have played a supportive role in market reforms; they have, else the market reforms in agriculture might have stalled, or at least would have been less successful. Nor am I arguing that local cadres are doing better than entrepreneurs in the reform era. Despite the rise of cadre opportunism and malfeasance, local cadres on balance have experienced a decline in power relative to entrepreneurs (NEE [1989]). Instead, I have described cadre opposition and malfeasance only to show how emergent markets are embedded in institutional contexts in which political actors play a pivotal role and how this embeddedness often distorts the allocative role of the market and impedes the role that entrepreneurs might play in economic development. Finally, I argue that such cadre malfeasance and opportunism pose an incorrigible problem for the state as long as grass-root cadres enjoy relative immunity from state sanctions against malfeasance, through protection by patrons in local government, and succeed in retaining control over in the allocation of public resources. As long as the organizational boundaries of the bureaucracy remain open, the state cannot effectively curtail cadre malfeasance; in short, its capacity to intervene to perform the regulatory role required to sustain the development of a market economy is reduced. A similar problem exists in Russia.

5. *Reorganization of the State Structure*

The subterfuge played by many village-level cadres in seeming to support reform policies, and yet in their actions undermining them, posed a difficult dilemma for the state. The very people whom the state relied upon to serve as functionaries in the implementation of reform policies were instead frequently the source of the state's difficulties. Not only were many village cadres deeply involved in venal pursuit of private gain by drawing on their positions in networks that gave them privileged access to both public and private resources, but they posed an obstacle to the state's new market-oriented rural development strategy which tried to encourage private entrepreneurship as a means of stimulating rural economic growth. Village cadres proved difficult for the state to bypass. Unlike recalcitrants in the state bureaucracy, who could be dealt with through established bureaucratic procedures such as lateral transfer, retirement, and expulsion, village cadres posed a dilemma requiring a different solution.

I pointed earlier to the lack of clear organizational boundaries between the state and local society. This condition grew out of the need for deep penetration by the state to carry out land reform and collectivization. In both periods of social change, the state needed to maintain a permanent political and organizational presence in village communities. In both cases, the penetration of state power into villages required the recruitment of village leaders into formal organizations which state cadres sought to use as a means of maintaining control over the villages. Open organizational boundaries were built into the design of the people's commune

system, which unified within a single organizational network activities of the state, economy, and society as part of the Maoist quest to merge state and society. The attraction of the Paris Commune ideal to Maoist ideologues reflected not so much a sympathy for its democratic idealism as the recognition of its symbol as a local government in which state and society were fused into one sociopolitical entity. Although the Chinese people's commune administration was formally the lowest level of state organization, the actual boundaries of the state could not be sharply drawn. Formal and informal ties linked the commune administration with village mass organizations – the militia, party branch, brigade, team, peasant association, women's association, and youth league. These organizations were not indigenous to village society, but were constructed by the state to secure its control over the villages. Hence the quasi-military organizational form of the people's commune system followed the logic of state power as it penetrated rural society (SCHURMANN [1964]).

Effective state interventions to shape and maintain market structures require a public bureaucracy akin to Weber's ideal-type of the legal-rational bureaucracy, capable of stable, methodical, rule-governed action based on written documents and files, strict subordination to higher bureaucratic levels, and the separation of the office from the personal interests of the officeholder. In the 1950s the Chinese Communists tried to construct a modern state by imitating the Soviet model (SCHURMANN [1964] and BARNETT [1967]). However, the goal of building a modern bureaucratic state was greatly weakened during the Great Leap Forward and the Cultural Revolution when Maoists tried to construct an alternative mobilizational state, which stressed the importance of the moral and ideological orientation of cadres, their leadership qualities, and their ability to make decisions case by case based on a generalist understanding and commitment to Maoist ideology.

Shortly after the start of market reforms, state leaders reorganized local government structures and tried to recruit better educated and younger bureaucrats. The subsequent effort to rationalize the state apparatus and enhance its level of professional competence were, I argue, in response to the greater regulatory demands imposed on government in the course of implementing market reforms. From 1983 to 1985 the Chinese state dismantled the people's commune system and in its place established the township government. Whereas the people's commune integrated the management of commune enterprises and agricultural production with the functions of local government, the policy of decommunization has attempted to take local government out of the business of economic management. To accomplish this, the commune has been reorganized into the township government to handle civil affairs and routine state administration. The responsibility for overseeing the commune enterprises and other economic units appears to have been entrusted to new corporate entities – vertically integrated corporations (*yitiao long*), horizontally integrated corporations (*nong gong shang lianhe gongsi*), and joint-stock companies (*lianheti*) or other shareholding arrangements. In the editorials and reports published in the party's newspapers and journals that emphasized the need for "sound government" staffed by "full-time" professional bureaucrats

we see the outlines of a regulatory state replacing the Maoist mobilizational state (*Renmin Ribao*, November 3, 1983, p. 2). Complaints made by village-level cadres in 1985 that the new township government had become more inaccessible were consistent with a trend towards closure of state organizational boundaries. Simultaneous to dismantling the people's commune, reformers reorganized village-level government by closing down the production brigade and team, replacing them with a smaller village committee and younger better educated cadres. In addition, mass-based organizations – the militia, youth league, women's association – were demobilized as active grass-roots organizations.

Despite the effort to reform local government, there remained considerable overlapping ties between the township government and the new corporations. The same cadres who were most influential in the township government frequently also held prominent positions in the new township corporations. Many of the same cadres who had served in the former commune administration remained prominent in the new township government. The county government experienced relatively little organizational change. The policy of fiscal decentralization strengthened the planning autonomy of the county government by cutting vertical ties that previously subordinated the county economic commission to provincial control. Its planning and economic commissions serve as the primary bodies involved in coordinating economic activity in the county. As a result the county government has come to assume a more important role in local economic development, giving rise to greater emphasis on achieving vertical integration within the county. However, only about 20% of village and township enterprises fall under the jurisdiction of the county economic commission, while the remaining are privately owned or leased, and depend on market allocation.

Three case studies detailed below illustrate the new regulatory role of the local state bureaucracy. In each case, units of local government intervened repeatedly in village disputes to provide third-party arbitration of disputes and enforcement of contractual agreements. The first case study cited below was reported by the *Fujian Daily* (LYONS [1994, 143f.]):

“In November 1985, Mr. Chen, of Nanan county, entered into a contract (*guolin chengbao hetong*) with the village committee of Zengcuo, in Huian county. Under the terms of the contract, Chen leased a 40-mu orchard for ten years, for total payments of 47,000 yuan. The orchard, opened by the village during the 1970s, had 800 longan trees and over 100 litchi, pear, and guava trees. The longan trees produced a bumper crop in 1987.

On 3 September 1987, a group of Zengcuo villagers raided Chen's orchard, just as the longan were ready for harvest. As soon as local officials heard of the incident they rushed to the scene to intervene, but a large quantity of longan had already been stolen. Three factors reportedly precipitated the raid: villagers felt that the contractor's rent payments were out of line with the market price of longan and the quantity produced; the contractor was perceived to have brought in a large crop with little effort; and the contractor's payments to the village were not divided up among individual households.

Mr. Chen, in seeking compensation for the damages he suffered, found himself embroiled in a dispute with the village authorities. His case dragged on for months. In April 1988, county officials ruled that the contract between Mr. Chen and Zengcuo village was in accord with the law and that the behavior of those plundering the longan orchard was illegal; nev-

ertheless, they decided that the two parties to the contract should renegotiate, because the village, when it leased out the orchard, set the rent too low. On 23 May, with township officials mediating, the two parties agreed to terminate the original contract. The village, accepting responsibility for the termination, undertook to repay 50% of the original contract amount (i.e., 23,500 yuan) and to return the original security of 8,600 yuan to Mr. Chen.

After terminating its contract with Mr. Chen, the village leased the orchard to another farmer, for 66,660 yuan. The new tenant also assumed responsibility for the 23,500 yuan due Mr. Chen under the village's prior agreement with Chen. The new tenant agreed to undertake management of the orchard according to prevailing regulations and to divide the harvest 60/40 with the village (keeping the larger portion for himself). Over the years, the village may well receive an additional 200,000 yuan.'

Although Zengcuo village reneged on its contract with Mr. Chen so as to enter a more lucrative one, *Fujian Daily* concluded that the dispute had been smoothly resolved, with both parties to the original contract satisfied. *Fujian Daily* did not report punishment of the villagers who plundered Mr. Chen's property."

The second case study also illustrates the growing reliance on third-party enforcement by local government of a contractual agreement between a group of entrepreneurs and the village government. Despite the opposition of a mobilized minority in the village, local government demonstrated credible commitment in maintaining its contract with a private entrepreneur (LYONS [1994, 145f.]):

"The hill in front of Dongqi village, in Ningde county, had been used to grow only a few potatoes. When the county sent technicians to do soil surveys, however, they discovered that the land on the hill was well-suited for growing fruit. A young farmer named Chen Pinshan took the lead in bringing together five partners and seeking a contract for development of a fruit farm.

The village authorities convened a number of meetings, to revise and amend the proposed contract with Chen's group. When finalized, the contract document carried the seals of the village committees and 95% of the village's people, and was notarized by the judicial authorities. It stipulated a term of 40 years (beginning January 1988), payment to the village of fees (*shanchang peichang fei*) in the amount of 230,000 yuan, and reversion of the fruit trees to village ownership after the 40 years, without compensation. The village set up a working group to begin using the money for electric lines, roads, running water, and other collective undertakings.

But a turmoil was brewing. Chen Shaoshan (an elementary school teacher, originally from Dongqi village) and his brother-in-law Ruan Hengsheng (a prefectural cadre, also from Dongqi) incited some of the villagers to oppose the contract with Chen Pinshan, by saying that the village's *fengshui* was being disrupted and that, as a consequence, the villagers would surely suffer. They also complained to higher authorities that, to plant fruit trees, the contractors were illegally destroying a forest. In fact, the forestry bureau determined that developing fruit production would have economic and ecological benefits and formally approved felling the pine trees on the hill.

A number of untoward incidents occurred after Chen and Ruan incited the villagers. (1) Two people in the village drowned after getting drunk. Some villagers, insisting that this was caused by disruption of the village's *fengshui*, brought in a sorcerer to conduct the appropriate rituals. (2) Surveyors hired by the contractors were threatened, and surveying markers on the hill were destroyed. (3) The wife of the village leader, who supported the contract, was beaten. (4) Those opposing the contract (mostly relatives of Chen Shaoshan and Ruan Hengsheng) fought with the contractors on a number of occasions, putting several people in the hospital. (5) Longan seedlings purchased by the contractors were stolen.

As of June 1988, nearly six months after the contract took effect, such incidents were still preventing Chen Pinshan and his group from going about their business. Several thousand

longan seedlings were still unplanted; the contractors losing money, told reporters that they now wished they had never entered the contract.

In June, the county government convened a meeting of county and township officials, aimed at resolving the dispute. The attendees believed that Chen Pinshan's contract was valid, that the contract was beneficial to the village's economic development, and that it should be enforced. The main reasons for the dispute were apparently a strong 'small peasant mentality' and a weak appreciation of the commodity economy on the part of some villagers. In addition, some villagers were envious, and some were motivated by superstition and clannishness. The county's public security bureau and the township police station initiated an investigation of the fights, taking three of the perpetrators into custody, fining five, and imposing restitution of the injured parties' medical bills.

The township Party Secretary led a team of officials into Dongqi, to convene village meetings and to discuss the matter with villagers in their homes. The fruit farmers signed an agreement with the township police station, providing for security and protection of their legal rights.

By July, the contractors were able to get to work developing their fruit farm."

A final case study documents the increasing reliance on formal litigation and third-party enforcement of contracts between private entrepreneurs and local cadres in the village government. It also highlights the precarious status of private entrepreneurs in an institutional context in which private rights based on legal contracts are poorly understood (LYONS [1994, 144f.]):

"Peng Yousheng's dreams were shattered on the morning of 27 October 1988. More than twenty villagers, led by Peng Jiexiang and his three brothers, raided Peng Yousheng's orange grove and carried off over 5,200 kilograms, worth 4,000 or 5,000 yuan.

The orange grove, 175 trees on 3.5 mu, belonged to the Xinyang #2 small group (*cunmin xiaozu*) of Chishi village in Changan county. The grove had yielded very poor harvests because no one took care of it, and had been virtually abandoned. Peng Yousheng leased the grove from the small group in 1982.

In February 1988, the four Peng brothers decided to reclaim the fruit trees and to divide them among households of the small group. When Peng Yousheng took the dispute to the county court, it decided in his favor: the contract would continue in force. After the prefectural court upheld the county's decision, the Peng brothers openly defied the courts, saying that their judgment were worthless pieces of paper and threatening to steal Peng Yousheng's oranges at harvest time. No one intervened to stop them.

At the end of the year, the county court ordered the Xinyang #2 small group to pay restitution in the amount of 1,200 yuan to Peng Yousheng. Participants in the plundering of his orange grove were to be fined 10 yuan each; those who had participated but failed to confess would be fined 100 yuan. Two leaders of the small group were taken into custody and fined 105 yuan each, for failure to enforce a decision having the force of law.

Fujian Daily examined four aspects of the case. (1) When reporters inquired into the perpetrators motives, they were shocked by the replies: Although the orchard's output had been low, everyone did get some oranges [when it was collectively operated]. After Peng Yousheng contracted the orchard, we didn't get to eat a single orange. Last year Peng Yousheng earned 7,000 or 8,000 yuan from the orchard, but he only paid 700 yuan in rent; he got too good a deal. This is a collective orchard – it wasn't sold to Peng Yousheng; everybody gets to share in collective things. Only six households did not participate in the plundering – because no one was home at the time. Villager Wang Pengfei told the reporters that, at the time of the raid, he happened to have gone into town to sell some radishes; otherwise, he would have gotten some oranges, too. (2) For the great majority of villagers, contracts, and court decisions are just pieces of paper. They supposed that, if everybody is unwilling to allow Peng Yousheng to continue leasing, they can simply stop him from doing

so. They were amazed to learn that dissolving a contract requires legal procedures, and couldn't understand why this is so. (3) After the incident, the county and prefectural courts repeatedly sent investigators into Chishi village, but no one would say who had instigated the incident or who had participated. One villager admitted that if he told the truth there would be reprisals later."

These accounts of government regulatory interventions reflect the increased regulatory burden of local government in resolving disputes over property rights and in providing third-party enforcement of contracts. In an institutional context characterized by a lack of understanding and acceptance of legally binding contracts and the rights conferred by them, monitoring and enforcement costs can be expected to be very high. As Thomas Lyons concluded, transaction costs "remain excessive" in rural China because the "prevailing constitutional framework makes property rights difficult to secure" (p. 166).

6. *The Transition to a Regulatory State*

From 1979 to 1985, ministries and commissions under the State Council issued more than four hundred new regulations involving agriculture alone. According to the Ministry of Agriculture, Animal Husbandry, and Fisheries, additional regulations were needed to meet the explosion of disputes and related litigations over property rights, especially rights over communal resources, protection of aquatic and forestry resources, marketing of farm produce, emergent labor markets, land use, taxation, and bankruptcy. The growing regulatory role of government sparked a rapid growth in administrative expenditures and a 78.2% increase in the number of government cadres, to a total staff of 7.34 million. Administrative expenditures increased from 1978 to 1988 by 388%, showing a rapid increase in transaction costs as the cost of administration grew from 5.1% of the state budget in 1978 to 9.0% in 1988. Increase in number of new government cadres shot up to an average of 330,000 per year, much larger than the 110,000 per year increases in the size of government prior to 1978. Susan SHIRK [1993, 136f.] suggests that local governments absorbed the greater proportion of increase in government staff. It was this level of government that assumed the main burden of state regulatory interventions, as the case studies illustrate.

From 1978 to 1985 the number of registered private businesses in China grew to 11.2 million, employing over 16.6 million people (*China Daily*, December 5, 1985, p. 4). Most of these businesses were rural enterprises established by entrepreneurs in villages and market towns. The most common forms of capitalization for family businesses are personal savings, bank loans, personal loans, and joint-stock arrangements. By the mid-1980s, however, interest in raising capital through issuing equities and bonds grew throughout China. In 1984 alone, capital raised through stocks and bonds in China amounted to about 5 billion yuan.

The rapid increase in the use of securities as a means of capitalizing new township and village firms sparked interest on the part of the state in regulating this

method of capital formation. As entrepreneurs and firms tried to raise capital by issuing securities, problems created by an unregulated capital market provoked state regulatory interventions. The state's interest in specifying and enforcing rules of the game of the emerging capital markets is illustrated in this statement by LIU DELIN [1985, 7f.], a reform economist:

"The norms of raising capital are incomplete and the convertibility of stocks and bonds into cash is not strong enough. Those (individuals and units) who organize the raising of capital in society usually do not have clear-cut and concrete rules formulated beforehand. The powers and the economic responsibilities of the shareholders are not stipulated. In some cases, only verbal agreements prevail and the necessary formal procedure is lacking. The share certificates issued do not show whether they are stocks or bonds or the kind of securities purported. Attractive terms, such as keeping the share capital intact, regular payment of interest and dividends, permission to withdraw midway from participation, and so forth, are offered to attract capital funds. Regarding the issuance of share certificates, some of the companies do not actually print and issue the share certificates; rather, they merely register the names of the shareholders, issue receipts to them, and on this basis pay them the share interest or dividends when due. Certain regions have gone so far as to resort to noncompensatory or irrecoverable capital-raising or compulsory levies and assessments, arbitrarily asking subordinate enterprises to subscribe to the shares, or ordering their staff members to buy the shares or bonds. In addition, our country has no stock market facilities and the banks do not discount shares or accept them as securities for loans. As a result, the convertibility of the securities into cash is extremely low or is nonexistent. All this not only brings confusion to the raising of capital in society, but also restricts the scope of the issuance of share certificates and bonds and hinders the raising of capital funds. This is definitely harmful to those enterprises which have bright prospects and are under capable management and to the relevant departments in rapidly raising large amounts of capital funds."

The logic of this line of reasoning points clearly to the need for establishing regulated capital markets.

As suggested by arguments advocating state interventions to establish regulated capital markets, the surge of private economic activities in the institutional context of unregulated emerging markets created demand for state regulation. In mountainous regions, peasant households responding to increased market demand for forest products harvested timber so extensively that forests were rapidly denuded (*Nanfang Ribao*, September 15, 1985, p. 2). Water conservation facilities in farming regions formerly maintained by the brigade fell into disrepair and were vandalized and equipment stolen. Farmland was lost to private housing construction and new industrial plants, giving rise to demand to regulate the use of arable land. The proliferation of fake and shoddy products produced by rural industries generated a demand from consumers and state-owned enterprises for regulation to protect the brand names of established enterprises and consumer rights (*Dazhong Ribao*, August 29, 1985, p. 1).

Demand for state intervention was occasionally generated by investigative reporting exposing social problems caused by unregulated markets. Following a newspaper report on abuses of child labor in Zhejiang, Wenzhou City, and Cangnan County sent a cadre-led work team to Jinxiang Township to investigate rural factories that employed child laborers. The work team reported that the age distribution of child laborers in Jinxiang Township ranged from 10 to 16 years, with the

mean age of 13.6 years; 83% (405) were young girls who came from surrounding villages to work in the factories. The level of illiteracy was high, at 30%. Only 20% had completed the first and second grades of primary school. The child laborers worked from eight to eleven hours a day, some worked extra night shifts. The wage scale was based on a piece-rate system, yielding daily earnings from 1.2 to 3 yuan. The report emphasized that poor working conditions were a primary concern (JOINT PUBLICATION AND RESEARCH SERVICE [1986a]):

“The child laborers are engaged in more than 20 different types of work in production, including lacquer paint touchup, gluing, platemaking, and plastic platemaking which uses xylene, cycloketone, and banana oil as the major solvents. These chemical raw materials are toxic, endangering the physical and mental health of the child laborers. The high-frequency machines commonly used by the small factories are also subjecting the working child laborers to the danger of radiation. The working conditions for the child laborers are often poor, with several types of work taking place in crowded workshops, and there is no special ventilation and lighting equipment in the factories and the employers do not issue any protective gear for work. We learned that the child labor problem is not confined to Jinxiang Township, it also exists in Qianku, Yishan, Bacao, Luput, and other places in Cangnan County in varying degrees.

Similarities between the conditions reported above and those of child-laborers during the Industrial Revolution in the West are striking.

State interventions in emerging markets aimed to protect state monopolies also contributed to the increased regulatory burden of the state. For example, the State Tobacco Bureau's (STB) response to rapid gains in market share by nonstate tobacco companies was to wage a virtual regulatory war against them. First the STB lobbied the State Council to promulgate the “tobacco monopoly regulation” which made illegal tobacco production by unauthorized private growers and the manufacture of cigarettes by township and village nonstate firms. As a way to reestablish its monopoly over tobacco leaves, the STB then issued 2 million new tobacco permits to small growers. It also tried to pressure local governments to close down tobacco factories that manufactured cigarettes outside of the state plan. Failing to shut-down the nonstate cigarette factories, the STB then attempted to curtail the flow of tobacco leaves to nonstate factories, and to have their products confiscated. The entire gambit of state regulatory mechanisms, including price controls, tax policy, police intervention, and the interdiction of the railway and telecommunication departments were employed by the STB in its war against nonstate competitors. These efforts ultimately proved ineffectual. With a profit rate of 500%, the cigarette market proved too lucrative for the STB to succeed in reclaiming the state's tobacco monopoly. After two years of fighting illegal manufacture of cigarettes, Ma Erchi, Deputy Director of the STB acknowledged that “tobacco factories not included in the state plan have not yet been completely closed down, the tobacco market is in disorder, and there is a very serious problem of counterfeit and black market cigarettes” (JOINT PUBLICATION AND RESEARCH SERVICE [1985, 39]).

An example of increased regulatory interventions in defense of nonmarket allocation of manufactured products is the state's attempt to eliminate free markets for

motor vehicles. Prior to market reforms, the State Bureau of Supplies was responsible for allocation of motor vehicles to state agencies and enterprises. However, the new prosperity of rural entrepreneurs stimulated a private demand for trucks and automobiles. Responding to the growing nonstate demand for motor vehicles, the State Bureau of Supplies and the China Motor Vehicle Company slated 76,500 trucks and automobiles for sale to rural areas in 1985. However, this allocation fell far short of demand. As a result, vehicles sold by the state could be quickly resold at windfall profits to eager consumers. Hence the used car market attracted speculators who drew on *guanxi* ties to secure the limited supply of motor vehicles allocated for sale in rural areas, and credit from the People's Bank to purchase the vehicles, which they could then resell at several times the purchasing price. Cadres in the state allocation bureau of the county government in particular could profit from the speculative sale of motor vehicles by taking bribes from speculators or participating in so-called "trading companies" that bought the vehicles legitimately and then marketed them in the free market for cars and trucks.

To curtail the speculation in motor vehicles and ensure that cars and trucks could be purchased at reasonable prices, the State Council issued a ruling in 1985 that 70% of all vehicles must be sold to cooperative enterprises, with the remainder available for individual consumers. Only firms or individuals who were issued permits were eligible to buy a car or truck from the state (*State Council Bulletin*, #6, March 10, 1985, pp. 124ff.). Temporary county allocation groups were created to review applications in order to screen out speculators. As a further safeguard against speculation, permits were made nontransferable, and the county allocation group was forbidden to receive any fees other than those covering the cost of handling the vehicle-purchase permit. It was also stipulated that cadres who "practice favoritism, engage in fraudulent activity, accept bribes or sell vehicle-purchase permits for profit" (pp. 124ff.) were to be prosecuted if caught. Such measures to restrict the secondary market for scarce state allocated resources not only increased the regulatory burden of the state, through the escalation of monitoring and enforcement costs, but also contributed to the perceived need to construct a legal-rational bureaucratic discipline capable of implementing state regulatory guidelines. Because regulatory interventions were directed at restricting individuals from making claims through *guanxi* ties on resources controlled by political actors, monitoring and enforcement were focused on policing boundary transactions at the interface of state and society. In other words, regulators perceived that the most effective administrative means of curtailing speculation between the state and market sectors was to take action aimed at monitoring the organizational boundaries of the state bureaucracy.

In a mixed economy, boundary transactions can generate windfall profits for cadres who use their positional power to maximize private gain in the marketplace. Cadres who accept bribes and gifts for services rendered obtain a transaction fee, but this is less than the value of the profit from the sale. Hence, such commodification of bureaucratic power is less profitable than direct participation in the market economy as *arbitrageurs* buying cheaply in the state sector to sell dearly in the

free market. For this reason, many cadres established or became shareholders in private "trading companies" or "trade centers" that bought products from the state to resell to the public. The activities of cadre-owned trading companies engaged in smuggling, speculation and profiteering grew to be so widespread that they provoked vigorous state interventions to investigate them, to force the resignation of cadres from private enterprises, to close trading companies that operated as fronts for cadres wheeling and dealing in the marketplace for private profit, or to incorporate such trading companies within the boundaries of the state organization.

According to Ren Zhonglin, Director of the State Industrial and Commercial Administration, in the first nine months of 1985 the state uncovered more than 27,000 illegal firms, involving more than 67,000 state cadres, and was in the process of investigating over 200,000 private trading companies, many in rural county towns and townships (*China Daily*, December 5, 1985, p. 1). Because access to capital was critical to private entrepreneurs, many tried to gain the favor of bank officers by offering them shares in their companies. So widespread was this practice that the People's Bank issued a ruling prohibiting officers and staff from holding concurrent posts in private businesses (JOINT PUBLICATION AND RESEARCH SERVICES [1986b]). The state's repeated efforts to impose sanctions against profiteering and speculation by cadres and to police its organizational boundaries as a means of curbing cadre malfeasance is similar to the intent of decommunization. They were part of the larger effort to achieve organizational closure; for without a degree of organizational closure, the state has little hope of intervening effectively in a regulatory capacity.

In response to the rapid expansion of market institutions, the State Council promulgated an ambitious agenda of new regulations that began to specify the legal norms for the new socialist mixed economy. It is impossible here to review all of these State Council documents because they cover diverse aspects of the emergent market economy. Instead I will characterize the essential elements of the new regulations passed by the State Council. *First*, new regulatory codes reflect a decisive move away from the Maoist era bureaucratic culture of *kadi-justice* towards a legal-rational form of bureaucratic authority. The legal norms are clearly stated, in abstract, universalistic categories, and are highly specific. They are based on individualistic assumptions about the rational interests of participating parties, defining and specifying legal rights and liabilities. Though there continues to be a tendency to subordinate the interests of individuals and private firms to that of the state, nonetheless the new regulations specify limits to state power and the rules and normative framework within which individuals, firms, and the state must act. Regulations on the reform of management in state-owned enterprises, for example, specify that factory directors can overrule planning directives that fall outside of narrowly defined guidelines and press criminal charges against government officials who encroach on the firm's autonomy. *Second*, the new regulations assume legally binding contracts, liabilities for breach of contract, the use of mediation or arbitration at a higher administrative level to settle disputes, and the right to litigation of disputes in the people's court. *Third*, to be legally binding, all con-

tracts must be written documents, not oral agreements. *Fourth*, the regulations are written in legal-technical language, are impersonal and objective in tone, and based on legal-rational mode of discourse, rather than the political discourse of the Maoist era. The responsibility for interpreting the new regulations is entrusted to the appropriate ministries and the people's court. If there are areas of ambiguity which require further refinement or if more detailed regulations are required, the responsibility to formulate them is entrusted to the appropriate state ministry. *Fifth*, all levels of the state organization must maintain files and documents. *Sixth*, officials and staff must have specialized knowledge and training, and the development of specialized administrative bureaus to implement the new regulations has been given high priority. Finally, the content of specific articles of the regulations reflects the attempt by the state to solve problems arising in the implementation of market reforms and to define and enforce the legal and normative framework of an emergent market economy operating side by side and interacting with a dominant state-run economy.

As examples of the scope and content of the new state regulations, I summarize two sets of regulations: the loan contract regulation and income tax regulation for nonstate enterprises.

The loan contract regulation specifies the legal norms governing loans made by banks to private firms and individuals. The document is organized into five separate chapters and contains twenty-four articles, which specify the rights of lender and borrower in making and implementing loan contracts, the terms for alteration and termination, and the liabilities for breach of contract and violation of the law. It states that loan contracts are legally binding as soon as they are signed and that both parties must observe the terms of the contract. The loan contract must specify the type, purpose, amount, interest rate, repayment schedule, method of repayment, terms of security or guarantee, and liability for breach of contract. The collateral offered to guarantee the loan must be sufficient to repay the loan. "Lenders have the power to check and examine the use of loans," and borrowers "must provide lenders with information related to plans, statistics, financial, and accounting statements and data." The loan contract may be altered or terminated only under conditions specified in the loan contract regulation. And liabilities for breach of contract are carefully defined and specified (*State Council Bulletin*, #7, March 20, 1985, pp. 133–136).

The income tax regulation for township and village enterprises contains twenty-one articles specifying the conditions for tax exemption and reduction, the accounting records to be kept by firms for tax purposes, the right of government tax bureaus to investigate for possible tax evasion, the rights and avenues for appeal by the taxpayer, and the rights and procedures to be used by the state's tax bureau to investigate and enforce tax laws. The income tax regulation also specifies a progressive tax schedule of eight grades with tax rates from 10% to a high of 55%. It entrusts the Ministry of Finance with the responsibility for interpreting the twenty-one articles and formulating more detailed regulations for their implementation. Taxes must be paid to local tax bureaus, which in rural areas means that

the county or township tax office must maintain detailed files and have the capacity to audit firms' accounts, the expertise to interpret tax rulings, and the organizational discipline to enforce tax rulings without partiality to personal consideration, methodically, continuously, and on a routine basis (*State Council Bulletin*, #12, May 10, 1985, pp. 351–356).

The central features of the modern bureaucracy – rule-governed action, subordination of lower levels to higher levels, the separation of the office from the officeholder, and the impersonal task-orientation of the modern office – generates an organizational culture less hospitable to the pervasive use of personal connections to gain official favors or services in violation of legal norms and procedures. Although new regulations were promulgated by the State Council, the challenge remains to monitor and enforce the regulatory guidelines at the local level. The reach of the central state attenuates as it confronts the growing power of local corporatist governments, rendering monitoring and enforcement of national laws and regulations inconsistent and often arbitrary. If the Chinese state is ultimately successful in building a modern legal-rational bureaucracy increased state autonomy will need to continue to develop at the interfaces of state and society.

7. Conclusion

When socialist states launch market reforms, they need to legitimize reform policies and intervene to establish the institutional framework of a mixed economy. Fundamentally this effort requires the state to specify a new structure of property rights and to reduce transaction costs both within the market sector and especially between the market and state-run sectors. I suggested the limits of the state's capacity for autonomous action to be those imposed by its embeddedness in *guanxi* ties and other exchange networks that interpenetrate the state and society, especially at the lower levels of the Chinese state. State structures characterized by relatively open organizational boundaries are likely to be susceptible to societal penetration and claims and are therefore less likely to be potent organizational actors in Weber's ideal bureaucratic organization. Thus the capacity of the state to intervene is weakened when opposition to its policies emanates from social groups that have penetrated the state. To attempt to resolve the dilemma of organizational recalcitrance, rulers tend to restructure the state apparatus to close the organizational boundaries of the state.

This paper points to the problem posed by the opposition and malfeasance of local political actors as indicative of the extent to which emergent markets are embedded in exchange networks, in which cadres play a pivotal role. I have documented how the state's capacity to implement market reforms was frustrated by local cadres whose opposition and malfeasance in the early period of reform posed an incorrigible problem to the state. The state tried to achieve greater closure of its organizational boundaries by restructuring the state structure (decommunization) and policing its organizational boundaries (sanctions and campaigns against cadre

malfeasance). The extent of openness and closure of these boundaries is relative, since the social boundaries of organizations are always to some extent permeable. Nonetheless, the flow of informal exchanges between the state and society through exchange networks can vary considerably depending on the extent to which the state polices its organizational boundaries.

Where market coordination of the mixed economy has expanded in scope, increased horizontal exchanges between buyers and sellers are likely to reduce the extent of vertical segmentation characteristic of command economies. Although in some sectors relative closure of the organizational boundaries of the state may result in a gradual decline in the importance of *guanxi* networks between the bureaucracy and social groups, this does not imply that economic transactions will become less embedded in personal connections. The continued growth in the scope and volume of market transactions in rural areas, where 80% of the population reside, and in rural-urban trade will most certainly stimulate the formation of horizontal linkages in society. To the extent that hierarchical forms of economic coordination remain dominant, however, personal connections between state agencies, firms, and households will continue to provide critical informal linkages.

The continued expansion and growth of free markets are likely to provoke sustained regulatory interventions by the state. The case studies of the monitoring of child laborers, the push to construct capital markets, regulation of public resources, and even market restrictive regulation as in the state tobacco monopoly, the motor vehicle market, and cadre-run trading companies all reflect state regulatory interventions in response to market action. The promulgation of hundreds of new regulations by the State Council in the mid-1980s has laid the legal foundations of a new regulatory state. They specify the institutional framework for a market economy. To institute a market economy, the state needs to demonstrate credible commitment and capacity to enforce the new rules of the game. Fundamentally, the Chinese state must learn to govern the economy by rule of law rather than by the fiat power of cadres. Macroeconomic regulation involves a retreat from such particularistic microinterventions as characterized the Maoist era. The essence of regulation, to enforce rule-governed action, requires the establishment of legal-rational authority. China is at the early stage of this transition.

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