

*Entrepreneurs and Politics in the Chinese Transitional Economy: Political Connections and Rent-seeking**

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This paper investigates the question of how state policy influences the interactions between cadres (party bureaucrats) and private entrepreneurs in China. We argue that state legitimization of private business has led to the interpenetration of the cadres' political power and the entrepreneurs' economic power. We propose that the importance of political connections for entrepreneurs to run their businesses has increased at the legitimized

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stage, compared with the initial stage. We also propose that entrepreneurs' profits have a positive effect on their political participation when markets develop. We test our hypotheses by using a 1993 nationwide survey of a sample of 1,440 entrepreneurs. Our findings suggest that state legitimization has led to the formation of a loose coalition between cadres and entrepreneurs, which in turn fuels rent-seeking behaviour.

Introduction

While China's economy has made great strides over the past 20 years, the transition from the planned economy to a market economy is far from over and continues to have profound social, political and strategic effects. In order to take a close look at the complexity of this economic transition, we examine the evolving relationship between government and entrepreneurs.

One of the most important developments in China is the rise of the private sector. By 1997, there were 961,000 private enterprises and 28,500,000 *getihu* (self-employed labourers) in China and 18% of employees were employed by the non-farming private sector.¹ A large number of Chinese entrepreneurs have achieved considerable economic power as the private sector has come to possess an increasing percentage of the economic pie.

Most writing on the transformation of the communist state can be divided into two opposite schools of thought. The state-centred approach focuses on the close linkage between the state and the rise of entrepreneurs. By analyzing data from Hungary in 1992, Rona-Tas, for example, claims that political power is converted into economic power in the market transition period in which markets are instituted by the state.² Scholars studying China have also credited the Chinese state with the rise of private business as it embraces a developmental role.³ According to Oi, fiscal decentralization from the central government provides an institutional basis for local government to support economic development.⁴ Some even claim that cadres (party bureaucrats) have made use of their political capital to grab market opportunities.⁵ For them, local governments and government officials themselves are entrepreneurs.⁶

The other school of thought investigates the power of entrepreneurs to transform the state.⁷ Market transition theory, for example, maintains that the market increases entrepreneurs' power at the expense of cadres' power. Cadres become less privileged as the market replaces the redistribution system on which their power relies. According to Nee, "Not only are the

direct controllers of the redistributive mechanism likely to experience a relative loss, but the value of their political capital accumulated through prior experience as cadres is likely to diminish as well.”⁸ In his study analyzing Chinese rural household data collected in 1984, Nee supports this theory by demonstrating that current and former cadres have no significant advantages in incomes. But he finds an anomaly in the fact that former cadres who became entrepreneurs earn high incomes. Nee attributes this contradiction to a mixed economy and contends that this will disappear as markets thicken.

The market transition school is very much in line with the study of entrepreneurs in the West and in the United States (US). Entrepreneurs’ role in economic development has been taken for granted. For example, Schumpeter, in his classic work, *Capitalism, Socialism and Democracy*, claims that the essence of capitalism is the process of “creative destruction” — the perpetual cycle of destroying the old and less efficient product or service and replacing it with new, more efficient ones.⁹ Thus many assume that the development of private entrepreneurs in socialist China would be at odds with the interests of a privileged party elite who are determined to perpetuate their power monopoly.

Scholars have also split over the issue of entrepreneurs’ autonomy in the transition from plan to market. One school of thought stresses independence for entrepreneurship. The drive to be autonomous pushes the entrepreneurs to explore market opportunities. The other school focuses the state’s close alliance with entrepreneurs, naming this alliance the “entrepreneurial state.”¹⁰

This paper investigates the interaction between the state and entrepreneurs in China. Building upon the existing theories of transitional economy and public choices (rent-seeking), we divide entrepreneur development into two stages. The first stage is the informal entry stage in which entrepreneurs invaded the state to gain entry into the market. The first period covered 1978 to 1988. The second stage started in 1988 when the state legitimized private enterprises and permitted them to hire up to eight employees.¹¹ Deng Xiaoping’s 1992 southern tour ended the anti-market environment following the Tian’anmen crack-down. By the end of that year, the report of the Fourteenth Party Congress stated that various types of ownership should develop together over a long period. The Fifteenth Party Congress in 1997 confirmed that the non-public sector is an important part of the socialist market economy and that individually owned businesses and private enterprises should be encouraged and developed.¹²

In the amended Constitution passed by the People's National Congress in March 1999, the phrase that individually owned and private business is a "complement to the public economy" was replaced by a phrase identifying it as an "important part of the socialist market economy."¹³ Unlike the initial stage, the state no longer restrained cadres from entering into private business.¹⁴

The main theme of the paper argues that while in the initial stage entrepreneurs gained entry to and limited autonomy from the state, a deepening interaction between entrepreneurs and the state after the state legitimization of private businesses has turned entrepreneurs and political leaders into a loose coalition. This coalition extends national markets while at the same time fuelling rent-seeking behaviour. Our findings suggest that entrepreneurs in a transitional economy like China have a dual role: while entrepreneurs were crucial to break the state's monopoly in the commodity market, their alliance with the state led to rent-seeking and prevented the old institutions from collapsing.

Thesis

We propose that cadres' political power and entrepreneurs' economic power are interpenetrating at the legitimized stage, while at the informal entry stage interpenetration is limited. At the first stage, due to state restrictions on the private sector, the chances of exchange of political and economic power are limited. At this stage, it is politically less safe for cadres to support private businesses. Moreover, because private businesses are restricted to a small scale, cadres seem to lack a strong incentive to support entrepreneurs. With the state legitimization of private businesses, cadres become more accessible to entrepreneurs. The interpenetration of political and economic power implies the importance of political connections for businesses. Entrepreneurs with political connections are more likely to be successful in their businesses. For this reason, they endeavour to make political connections.

We develop three sets of hypotheses to look at the relationship between entrepreneurs and political linkage in these two stages. Our first hypothesis states that there is a limited effect of entrepreneurs' cadre experience on profits at the initial stage of private business development. Our second research hypothesis is that entrepreneurs' past cadre experience is linked to profits at the legitimized stage of private business development. In the first and second hypotheses, we assume that former

cadres increased their profits through political connections that they accumulated when they served as cadres. The third hypothesis suggests that entrepreneurs' profits have a positive effect on their political participation when markets develop.

Data and methods

We rely on the 1993 nationwide survey of a sample of 1,440 entrepreneurs (*siying qiye zhu*) in China, which was conducted by the Federation of Industry and Commerce (FIC). Because the FIC is not an administrative organization, entrepreneurs under the survey were more likely to express their opinions candidly. We supplement this data with data from our field work interviews conducted in the summers of 1996, 1997, 1998, and 1999.

The sampling method of the nationwide survey was multi-stage stratified random sampling. For a sample frame, the lists of private enterprises registered with the Industry and Commerce Bureau was used. The sampling ratio was 1.2%. At the first stage, the sampling units of province were decided according to the ratio of urban-rural and industries. At the second stage, the sampling units of city and county were decided according to the proportion of private business in each province. At the third stage, for all selected cities and counties, private enterprises were grouped according to two dimensions of rural-urban and industries, and in each group, private enterprises were chosen randomly. The survey was conducted in 1993. Response rates were 84%.

Multiple regression analysis is used for the tests of the three hypotheses presented in the previous section. To test our first hypothesis, the 1987 profits are regressed on entrepreneurs' status as cadres and other variables. For our second research hypothesis, the 1992 profits are regressed on entrepreneurs' cadre experience and other variables. The test of our third hypothesis is conducted by regressing the self-reported degree of political participation on 1990 profits and other variables.

For the regression of 1987 profits, a subset sample of respondents who registered their businesses before 1987 is used to exclude those who had not started in business until 1987. For the regression of 1992 profits, the total sample is used. Table 1 and Table 2 report the description of variables for the total sample and the subset sample. The characteristics of test variables for the subset sample are similar to those for the total sample. 14% and 13% of entrepreneurs are former cadres in the total sample and in

Table 1. Description of Dummy Variables

Variables	Code value	Univariate distribution	
		Subset sample: entrepreneurs who registered before 1987	Total sample
Gender (Male = 1)	Male = 1	533 (589)	1293 (1436)
Former cadre	Yes = 1	76 (591)	195 (1440)
Province			
Southern coastal	Yes = 1	224 (591)	499 (1440)
Northern coastal	Yes = 1	143 (591)	415 (1440)
(Inland)	(Reference category)	224 (591)	526 (1440)

Note: Total numbers are given in parentheses. The southern coastal provinces include Guangdong, Zhejiang, Jiangsu, and Fujian. The northern coastal provinces include Liaoning, Beijing, Tianjin, Jilin, Shanghai, Shandong, and Heilongjiang.

Table 2. Description of Numerical Variables

Variables	Univariate distribution	
	Subset sample: entrepreneurs who registered before 1987	Total sample
Age	44.64 (8.79)	42.77 (9.31)
Education (Unit: years of education)	10.20 (2.71)	10.69 (2.80)
Business experience (Unit: years of business experience)	5.48 (2.22)	5.93 (3.40)
Initial number of employees	18.98 (29.75)	20.10 (35.32)
Initial business space (Unit: logged square metres)	4.87 (1.48)	5.00 (1.43)
Initial capital (Unit: logged RMB100)	5.04 (2.82)	5.64 (2.86)
Re-investment (Unit: logged RMB100)	1.88 (2.69)	2.95 (3.47)
Profits (Unit: logged RMB100)	4.79 (3.02)	6.23 (3.01)
Degree of political participation (1: lowest – 10: highest)	na	6.15 (1.96)

Notes: SDs are given in parentheses.
na: not available.

the subset sample, respectively. The means of years of education are 10.7 and 10.2 years in the total sample and in the subset sample, respectively.

Two dependent variables, *1987 Profits* and *1992 Profits* are transformed into logarithmic forms. Four cases have negative profits in 1992. Because of the logarithmic forms, these four cases were necessarily excluded from the analysis. Distortion of analysis from excluding these four cases is minimal, as these cases comprise only a small portion of the total cases, less than 0.3%. Logarithmic transformation of profits makes it possible to estimate the effects of a one-unit change in the independent variables on percentage changes in profits.

The third dependent variable, *Degree of Political Participation*, is measured by entrepreneurs' self-reports. Respondents were asked to check one point among ten points from one (the highest degree) to ten (the lowest degree) to indicate their degree of political participation. For convenience of interpreting results in the multiple regression, we transform this variable so that it represents one as the lowest degree and ten as the highest degree.

Former Cadre is a dummy variable coded as 1 if an entrepreneur is a former cadre and 0 if not. As the focus of this study is political connections from cadre experience, only entrepreneurs who had been cadres in the party-state organizations are included in the category of former cadre, while entrepreneurs who had been cadres in enterprises are excluded from this category.¹⁵ Table 3 displays the distribution of former entrepreneurs' cadre positions. Most of the ex-cadre entrepreneurs were from low-level party-state organizations.

Two variables, *Education* and *Business Experience*, are included to measure human capital. In the tests of the first and second hypotheses, *Education* is measured by the number of years of formal schooling completed by the respondents. In the third hypothesis test, as a non-linear

Table 3. Entrepreneurs' Former Cadre Positions

Position	Subset sample	Total sample
Department (<i>ke</i>)	16	71
Division (<i>chu</i>)	6	23
Bureau (<i>ju</i>)	2	5
County (<i>xian</i>)	3	8
Township (<i>xiang</i>)	0	6
Town (<i>zhen</i>)	49	82
Total	76	195

relationship between education and the degree of political participation is expected, four dummy variables are used to represent five categories of educational level: *Primary School or Below*, *Middle School*, *High School*, *Vocational School*, and *College or Above*. The category omitted is *Middle School*. *Business Experience* is measured by the number of years of doing business, which is calculated by subtracting the year of registration from the year of 1993.

Two demographic variables are included for controls. *Gender* is a dummy variable, 1 for males and 0 for females. *Age* is the reported age at the time of the survey. In the test of the first and second hypotheses, four variables are included for controls. *Initial Number of Employees* is measured by the number of employees when an entrepreneur started his or her own business. *Initial Business Space* is measured by area of business place. *Initial Capital* is calculated by fixed and circulating capital when business was started. *Re-investment* is measured by initial re-investment and 1990 re-investment for 1987 profits and for 1992 profits respectively. Logarithmic forms are used for *Initial Capital*, *Business Space*, and *Re-investment*. In the test of the third hypothesis, the effect of regional disparity is controlled. Two dummy variables represent three categories of province: *Southern Coastal*, *Northern Coastal*, and *Inland*. The reference category is *Inland*.

Results

Table 4 presents the results from four different regressions of profits. 1987 profits and 1992 profits are regressed on the same variables to examine whether there are differences in the effects of test variables on profits between the initial stage and the legitimized stage of private business development. Two different sets of variables are used to explore whether there is an interaction between *Education* and *Former Cadre*.

Model 1 and Model 2 in Table 4 show that no test variables are significant. Neither cadre experience nor education significantly affected profits in 1987, nor did the interaction between the two. This result supports the first hypothesis, which predicts a limited effect of entrepreneurs' cadre experience on profits at the initial stage of private business development.

Model 3 in Table 4 demonstrates that all test variables are significant. The coefficient of former cadre is 0.585, which means that ex-cadre entrepreneurs earn profits 58% higher than non-ex-cadre entrepreneurs,

Table 4. Regression of Entrepreneurs' Profits in 1987 and 1992 on Cadre Experience, Education, and Business Experience

Variables	1987		1992	
	Model 1	Model 2	Model 3	Model 4
Intercept	2.641* (1.079)	2.436* (1.101)	3.558*** (0.632)	3.861*** (0.644)
CONTROL VARIABLES				
Gender (Male = 1)	0.600 (0.420)	0.612 (0.420)	0.609* (0.254)	0.596* (0.253)
Age	0.001 (0.014)	0.001 (0.014)	-0.015 (0.009)	-0.015 (0.009)
Initial number of employees	0.010* (0.005)	0.010* (0.005)	0.002 (0.002)	0.002 (0.002)
Initial business space	0.004 (0.087)	0.006 (0.087)	0.052 (0.057)	0.052 (0.057)
Initial capital	0.023 (0.047)	0.022 (0.047)	0.114*** (0.030)	0.118*** (0.030)
Re-investment	0.365*** (0.045)	0.365*** (0.045)	0.216*** (0.023)	0.219*** (0.023)
TEST VARIABLES				
Education	0.063 (0.046)	0.079 (0.049)	0.058* (0.028)	0.030 (0.030)
Business experience	0.010 (0.054)	0.014 (0.054)	0.095*** (0.024)	0.095*** (0.024)
Former cadre	0.152 (0.362)	1.432 (1.398)	0.585* (0.229)	-1.437 (0.887)
(Not former cadre)	—	—	—	—
INTERACTION				
Education × Former cadre		-0.122 (0.129)		0.179* (0.076)
Adjusted R-Square	0.14	0.14	0.12	0.13

Note: SEs are given in parentheses.

* p < .05 ** p < .01 *** p < .001

controlling for all other variables in the Model. The coefficient of education is 0.058, meaning that each additional year of education increases profits by 5.8%. The coefficient of business experience is 0.095, which means that each additional year of business experience increases profits by 9.5%.

The results of Model 3 support the second hypothesis by demonstrating that cadre experience has a positive effect on profits at the legitimized stage of private business development. Contrary to the market transition theory, the effects of entrepreneurs' cadre experience on economic gains increase as markets develop. The returns of education increase with the development of markets, as the market transition theory predicts. Both political connections and merit appear to become important.

In order to examine whether educational effects on profits differ between ex-cadre entrepreneurs and non-ex-cadre entrepreneurs, an interaction between education and former cadre is added in Model 4. The coefficient of the interaction is significant, which means that the effect of education depends on cadre experience. The main effect of education (0.030) is the effect of education for non-ex-cadre entrepreneurs. This coefficient is not significant. In other words, education does not significantly affect profits for non-ex-cadre entrepreneurs. The coefficient for the interaction (0.179) is the additional effect of education for ex-cadre entrepreneurs, so the effect of education for ex-cadre entrepreneurs is 0.209, the sum of the main and additional effect. The differences in profits between ex-cadre entrepreneurs and non-ex-cadre entrepreneurs become larger as the level of education increases. For instance, among entrepreneurs with 12 years of education, ex-cadre entrepreneurs, on the average, earn profits 71% more than non-ex-cadre entrepreneurs. On the other hand, among entrepreneurs with 16 years of education, ex-cadre entrepreneurs, again on the average, earn profits 143% more than non-ex-cadre entrepreneurs. This result shows that cadres, especially those who have higher levels of education, have advantages in profit making at the legitimized stage.

Table 5 reports the results of regression of entrepreneurs' self-reported degree of political participation on 1990 profits (Model 1) and controlling for cadre experience and other variables (Model 2). In Model 1, only one variable, 1990 profits, is included to examine the total effect of profits on entrepreneurs' self-reported degree of political participation. Model 1 in Table 5 shows a significant positive total effect of profits on the degree of political participation. The standardized coefficient of profits in Model 1 is 0.183, which means that with an increase of one standard deviation in profits, entrepreneurs' self-reported degree of political participation increases by 0.183 standard deviation.

In Model 2, besides the effect of profits, several control variables show significant effects on the degree of political participation. Business

Table 5. Entrepreneurs' Self-Reported Degree of Political Participation Regressed on Profits (Model 1) and Controlling for Education and Cadre Experience (Model 2)

Variable	Model 1		Model 2	
	Unstandardized coefficient	Standardized coefficient	Unstandardized coefficient	Standardized coefficient
1990 Profits (logged)	0.122*** (0.017)	0.183	0.080*** (0.019)	0.119
Former cadre			-0.025 (0.180)	-0.003
(Not former cadre)			—	
Business experience			0.101*** (0.019)	0.151
Education				
Primary school or below			0.276 (0.215)	0.036
(Middle school)			—	
High school			0.074 (0.156)	0.014
Vocational school			0.274 (0.218)	0.035
College or above			0.481** (0.180)	0.077
Gender (Male = 1)			-0.258 (0.203)	-0.003
Age			0.022** (0.007)	0.091
Province				
South coastal			-0.492*** (0.144)	-0.100
North coastal			-0.322* (0.152)	-0.062
(Inland)			—	
Intercept	5.866*** (0.096)		4.798*** (0.370)	
Adjusted R-Square	0.03		0.08	

Note: SEs are given in parentheses.

* p < .10 ** p < .05 *** p < .001

experience has a significant positive effect on the degree of political participation. Entrepreneurs with college or above educational level show a significantly higher degree of political participation compared with entrepreneurs with middle school educational level. Entrepreneurs in the southern coastal and northern coastal provinces show a significantly lower degree of political participation compared with entrepreneurs in inland provinces. Age has a positive effect on the degree of political participation. Cadre experience does not significantly affect the degree of political participation.

By comparing the unstandardized coefficients in Model 2, we can examine the relative importance of independent variables on the degree of political participation. Business experience has the largest standardized coefficient and profits have the second largest standardized coefficient. This indicates that profits have a relatively strong effect on the degree of political participation among independent variables in the model.

Effects of Liberalization Policies

The initial stage of private business development started with limited permission from the state in the late 1970s and the early 1980s. However, at the initial stage, the state remained ambivalent towards private business.¹⁶ While allowing private business, the state put rigid restrictions on it. First, in order to prohibit the outflow of labourers from the public sector, only unemployed persons or retirees with certain skills in the city were permitted to engage in private business. Second, the state restricted the scale of private business by limiting the maximum number of employees to seven.¹⁷ Third, the previous repeated political campaigns against the formerly rich led to suspicious, especially among the urban elite. Commerce was called speculation and thus seen as unproductive or even as theft. There was indeed an element of speculation in entrepreneurs' trade in the early stages of transition in China because the markets under state planning were so fragmented, and the transfer of resources from one to the other could be highly profitable. These historical reasons and state anti-private business policies meant that most Chinese entrepreneurs at the beginning were marginal people: former convicts, the old, the retired and farmers, all of whom were not able to get state jobs. Those people were the pioneers of business in China.

In 1988, the state permitted private enterprise to exist. The new policy loosened the grip of planning and allowed cadres to deal openly with the

private sector. After Deng's southern tour in 1992, the ideological barrier to markets was completely gone. Many cadres began to engage in entrepreneurship activities.¹⁸ Legitimization had changed the relationship between entrepreneurs and cadres. As entrepreneurs expanded their market activities into the state sector, political connections became increasingly important for profit making.

The government's liberalization policies affect the interaction between entrepreneurs and cadres in several ways. The first effect of this liberal policy was to divide the bureaucrats' interests, complicating the relationship between cadres and entrepreneurs. "In the old more ideological era, even powerful ministries had limited scope and were subject to sharp swings of policy."¹⁹ The legal recognition of private enterprise has enabled cadres to negotiate deals openly, often in competition with rival bureaucrats from other government offices. To open real estate businesses in Shanghai, for example, entrepreneurs have to go through as many as 17 different kinds of permits with a complex web of people from the relevant ministries, local government and local party office.²⁰ Each bureau would charge a fee while some of the money dropped into the pockets of cadres.

The second effect was the expansion of market activities to other sectors of the planned economy. Since economic reform has been limited in such key elements like as property rights (land, housing and capital), legitimization of private businesses created ample opportunities for government officials to make money because they were still in control of essential economic elements (capital goods, financial capital, land and information).

For instance, Jane Duckett has demonstrated the role of the cadres in real estate and commercial development in Tianjin. Their role in market expansion was so important in the 1992 real estate boom that Duckett referred to them as the entrepreneurial state.²¹ With cadres' support at all levels, real estate businesses boomed. By 1992, there were 12,400 real estate development companies, 4,700 repair and management companies and mediation agencies employing 2,500,000 workers.²² This development was unprecedented, since the government only started to allow the land development in 1987. This cadre-indulged market development helped the land and real estate market development but also led to a Chinese real estate bubble. In 1992, the investment in real estate increased 117% over 1991, reaching RMB 73 billion.²³ Parallel practices of tax exemption for import subsidies, export rebates, and public purchasing constituted instruments of central planning.

Third, the legitimization encourage government officials to become entrepreneurs themselves. Many cadres became entrepreneurs seeking profits.²⁴ Since the state legitimized private business, the most powerful entrepreneurs have been the so-called Red Princes and Princesses — the children of senior officials. For example, Deng Xiaoping's daughter Deng Nan is vice-minister of the State Science and Technology Commission, making deals with entrepreneurs and enriching herself. Deng's son-in-law, He Ping, is the biggest arms dealer in China. Chen Yuan, deputy governor of the People's Bank of China, is the son of senior leader Chen Yun. "The younger princeling offspring of current leaders are often the ones first able to strike deals with foreigners and mobilize local resources to set up factories. Chen Weili, the daughter of Chen Yun, is deputy chairwoman of China Venturetech and Wu Jianchang, chairman of the China National Non-ferrous Metals Industry Corporation, is the son-in-law of Deng Xiaoping."²⁵

Government managers also began to devise their own methods of privatization, giving rise to asset stripping of state enterprises. Since it was now politically acceptable to become entrepreneurs, an increasing number of government officials began their capital accumulation by stripping the assets of state enterprises. In the short term, this aggravates the financial problems of the state-owned enterprises (SOEs), which in turn will create a major financial crisis in the economy by rendering many SOEs worthless and leading them to default on their debts to banks. Against this background, entrepreneurs try their best to build a coalition with the cadres. Some even use money to get political appointments. Some recent village elections have been openly run by entrepreneurs.²⁶

The participation of government officials in the market is a complex issue. On the one hand, their market participation has led to more commodification of goods in Chinese markets. As cadres try to make money by selling planned goods at market prices, gradually prices of most commodities become determined by the market. But, on the other hand, their control over the market has also led to official profiteering, corruption and rent-seeking.

Diversified Reasons for Political Participation

We realize that the entrepreneurs' self-reported degree of political participation in the survey data has limitations for measuring participation. First, perception of political participation may be different from actual political activities. Second, it is unclear how entrepreneurs understand the meaning

of political participation. Previous studies show that entrepreneurs participate in politics in several ways: participation in formal political institutions such as the People's Congress,²⁷ participation in elections at the grassroots level,²⁸ and becoming active members in state-guided associations for private business such as a self-employed labourers' association, private business associations, and the FIC.²⁹ In addition to these formal ways of participation, entrepreneurs participate in politics in informal ways.³⁰ Close examination of entrepreneurs' political participation might be a useful research topic in the future.

The reasons why entrepreneurs want to participate in politics can be inferred. First, entrepreneurs want to make political connections for their businesses. Entrepreneurs who engage in manufacturing non-competitive or less competitive products would prefer government protection, continued oligopoly, fixed domestic shares, high consumer prices, etc. These entrepreneurs often concentrate their efforts on being active in local politics. These entrepreneurs try to make friends with government officials. For those entrepreneurs whose products are competitive nationally, the emphasis has to be on high quality goods at lower cost, greater internal efficiency, possible partnering with foreign firms, layoffs and wage flexibility. Some entrepreneurs who are trying to make good economic decisions will press for deregulation and open transparency for government policies (such as ending industrial subsidies to state factories, or allowing bigger stores, or more open bond markets, etc.). Thus their participation in politics would potentially hurt the planned structure and vested interests. Some even express their voice in the media, the party congress and local government. The expansion of a marginal class, entrepreneurs, into Chinese politics may have a positive development in the long run.

Second, still others want to participate in politics and become officials themselves both because they realize that they could make more money by becoming officials and because there is still a strong anti-private entrepreneur culture in the government. For example, although the private sector has a record of 90% repayment rates for loans, it is very difficult for private entrepreneurs to get loans and credits, because for cadres defaults by private clients have more serious consequences for their careers than defaults from public sector borrowers.³¹

Third, other entrepreneurs want to participate because they are interested in politics. Sometimes, they openly use their money to get appointed or elected. For example, in one township election in Guangdong, an

entrepreneur, Lin Zhao, paid each delegate US\$1,000 (RMB 24,000) to get himself elected as the township head.³² An increasing number of entrepreneurs have become government officials.

In short, the entrepreneurs, bureaucrats, and political leaders all do their utmost to protect their own interests. Thus, gradually, they have formed a loose coalition. While government officials hand out rewards (policies and privileges) to entrepreneurs for their political cooperation and their own benefit, the entrepreneurs make use of their political connections to enrich themselves. Chinese people call such a loose coalition *quanqian jiaoyi* (power/money exchange).

Implications of *Quanqian Jiaoyi*

Quanqian jiaoyi will have political, economic and social implications. First of all, cadres use their political power to get involved in market activities, while the entrepreneurs use their economic power to gain entry into the political arena. Both cadres and entrepreneurs can make money by this mutual dependence. In this socialism with Chinese characteristics, the government retains considerable control over the resources while allowing for personal profit.

Since the party hierarchy still controls important channels of the economy, entrepreneurs use their political skills to intervene in markets for their own economic gain, a process that gradually undermines the process of deepening reform in price and finances. For example, their control over the credit market has enabled government banking officials to become rich, because entrepreneurs try to bribe the officials to get credit. The most famous case was Mu Qizhong, who made millions in the mid-1980s by exchanging old Soviet planes for Chinese consumer goods.³³ When the state policy became more tolerant towards private entrepreneurs, Mu made friends with important people in the government both at the centre and at provincial level. The state banks, the only legal, and the largest, creditors in China, continued to provide him with credit although he had not produced one profitable product or service since 1990. All he did was to borrow from one bank to pay another. Since he hired hundreds of people, donated to charities, and made friends with the powerful, he was able to continue to survive without problems until 1999.³⁴

Second, *quanqian jiaoyi* could reduce the efficiency and competitiveness of the marketing system by discouraging new entrants from joining the market. Competition and efficiency become secondary considerations,

and markets may not operate in the interests of society but rather those of a selected group.

Third, *quanqian jiaoyi* encourages rent-seeking among entrepreneurs and cadres. While more cadres have developed a vested interest in retaining the power of allocation and have resisted furthering market reform, entrepreneurs who have connections are not interested in further reforming the distorted economy either. Thus *quanqian jiaoyi* reduces the incentives for structural change. As a result, a substantial portion of the planned economy remains intact. Thomas Rawski points out that China's economy regularly shrinks during three months of each year and stagnates for another quarter, with all the growth occurring in the second and fourth quarters.³⁵ "The seasonal profile is typical of a socialist economy driven by planned investment. The socialist calendar is punctuated with regular bouts of storming work (*tuji*), the spurt of activity before the end of each planning period in an attempt to achieve 100% fulfillment, with a subsequent period of slack until the next target date approaches.... This suggests that limited reform of investment, which accounts for roughly two-fifths of Chinese aggregate expenditure, may lie at the root of China's growth economic difficulties."³⁶

A Chinese commentator reports that "Most investment projects are funded not based on an investors' pursuit of profit maximization, but on administrative power."³⁷ According to a World Bank report, excessive government intervention has hampered the development of China's nascent capital markets with primary markets, most acutely affected.³⁸ The state control over interest rates and quotas on credit is the continuation of the planned economy. Equities are rationed under credit plan quotas and exposure to shareholder scrutiny is slight. All the unreformed aspects provide lucrative opportunities for cadres and entrepreneurs alike. In Guangdong, the issue of *neibugu* (the unpublished stocks) reached RMB10 billion in 1992.³⁹

Inside trading has become a gold mine for government officials, contributing to high volatility and rampant speculation in China's stock and financial markets. For example, before China devalued its currency in 1993, quite a few government officials who had access to the information began to exchange *renminbi* into American currency. The official exchange rate was US\$1 to RMB5.6 at that time. By collaborating with banking officials, more than RMB10 billion was exchanged before the official announcement was made (the new exchange rate is US\$1 to RMB8.3), making quite a few officials millionaires overnight.⁴⁰

China is not unique in such rent-seeking activities. J. M. Buchanan, the 1986 Nobel Laureate in economics, has used the US case to illustrate the extent and harm of rent-seeking activities.⁴¹ He points out a range of rent-seeking activities, including “governmental licenses, quotas, permits, authorizations, approvals, and franchise assignments.”⁴² Bhagwati also argues that state controls on trade through tariffs and other barriers leads to wasteful competition for import licences, tariff-seeking, tariff evasion, and lobbying by private entrepreneurs while rent-seeking forms a “subset” of the more general phenomenon of “directly unproductive profit-seeking activities” ranging from price distortion-triggered activities and distortion-triggering activities.⁴³

In China, the rent-seeking activities cover a greater area since the state was in control of most resources. Rent-seeking has pushed prices towards market prices in some markets (most commodities), putting officials with power to grant favours effectively in competition with each other. They have not led to market-driven prices in the financial and energy sectors, but rather to a strange sort of government/robber baron monopoly that would make John D. Rockefeller proud. For example, the state monopoly control over power and water led to the rise of *dian laohu* (electricity tigers) and *shui laohu* (water tigers), making the officials in charge of those key resources wealthy. Entrepreneurs have to spend a substantial amount of time, money and effort dealing with those tigers, thus reducing their potential productivity because of high transaction costs. A well-known Chinese proverb vividly describes how the politically powerful are seen to divert public property to their own economic gain:

He's got the finance system on his left,
 And the banking network on his right.
 He taxes all of industry
 With all his beastly might.
 He's the king of electric current
 And prince of the water pipe,
 But what's he care for kids at school?
 Not a strip of tripe!

The lobbying of both cadres and entrepreneurs for keeping the status quo increased rapidly in the second stage as vested interests openly challenged the additional reforms. For example, some local entrepreneurs and some local cadres held banquets to celebrate China's failed attempt to join the World Trade Organization (WTO) in December 1994.⁴⁴ In 1999,

Minister of Telecommunications Wu openly protested against China's entry into the WTO.⁴⁵

Fourth, *quanqian jiaoyi* weakens the development of professional managers. Our survey analysis shows that education positively affects profits only for entrepreneurs with cadre experience at the legitimized stage. In other words, without political connections, merit hardly gets paid. It is for this reason that Chinese growth has not developed real business leaders. *Quanqian jiaoyi* is paternalistic in nature. It is difficult for entrepreneurs to make substantial profits without political connections. But dependence on politics can also constrain their choices and aspirations, making success in the market place difficult. As a result, most business decisions are *guanxi* (personal connections) driven rather than process-driven, tending to be risk-averse.

Fifth, *quanqian jiaoyi* also increases transaction costs. Williamson, as early as 1986, pointed out that when transaction costs are higher, the market becomes less viable. As transparency or knowledge and rationality become scarcer, the more the resources involved are specific and therefore limited, leading private interests to prevail over observance of the law in contractual relations.⁴⁶

Finally *quanqian jiaoyi* is authoritarian and not transparent in nature, creating problems of social justice. Since formal channels for grievances are limited, *quanqian jiaoyi* in China can become an explosive issue as it further restricts new entries into business.⁴⁷ A best-seller in China was the book *Pitfalls of Modernization*, in which He Qinglian suggests that the largest financial gains were often made by those linked to the party-state bureaucracy, not by those individuals who work independently of the state.⁴⁸

Since cadres decide who should get what privileges or opportunities, there are opportunities for personal enrichment. When the economy was good, as in the mid-1990s, many people might be content to accept kickbacks, contract padding, politically motivated investments, and pay-offs to political parties as facts of life. But as growth has slowed down and more workers have been thrown out of work, social unrest might develop and corruption become less tolerated.

Corruption-related crime increased rapidly after 1993, when 30,000 high ranking officials, including 90 provincial top leaders were indicted. Between 1990 and 1998, corruption-related economic crimes reached over one million. From the death penalties listed in the notes,⁴⁹ we can see the high-level corruption among the party and state managers who occupied important positions in banking, finance, power, coal, land, and other key

resources. Since millions can be made in such a short time, not even the death penalty can stem the tide of official profiteering.

Political power has become the source of money making. The gap between government officials and private entrepreneurs is a large one and creates a psychological imbalance. Since there is no other countervailing force supervising the officials, corruption has soared.⁵⁰ The sense that corruption is overwhelming is captured in the following saying from the 1990s:

If you line up all the officials and shoot the whole line, a few innocent ones are going to get killed; but if you line them up and shoot only every other one, an even larger number of the guilty will get away.

The problems of high-level corruption in China show that politics and economics go hand in hand. Hayek warned in 1944 that the root of the doomed experiment of socialism is an unconstrained and totalitarian government.⁵¹ Thus the first item on the agenda of post-socialist reform is to find ways to reduce the scope of government control rather than simply to copy superficially many secondary institutions of modern market economies.

Precisely because of nontransparency between business and government, China is ranked low (100) in terms of economic freedom, while Hong Kong is ranked the highest (1).⁵² The much talked about comparison between China and Russia has been that Mikhail Gorbachev got his strategy backwards and Deng Xiaoping was right to put perestroika or economic change ahead of political glasnost. The Chinese case shows that both Gorbachev and China's Deng Xiaoping got it wrong. One cannot have one reform without the other.

Conclusion

This paper shows that the process of economic transition is complex. The Chinese case shows the limits of the state-led development model. One can never assume that state liberalization will lead to more opening of the market in all areas of the economy. Whereas liberalization and stabilization policies can be seen as (partly) intended processes, the rent-seeking coalition is largely an unintended process. The close relationship between power and money has created new vested interests, which may block further loosening of state power.

The findings in this paper show that to understand the interaction between political and economic power, it is important to see economic

transition in terms of different stages. Cadre experience significantly increases entrepreneurs' profits only at the legitimized stage of private business development, not at the initial stage of private business development. Contrary to the market transition theory, the benefits of entrepreneurs' cadre experience increase as the market develops. The legitimization of private business facilitates the symbiotic relationship between entrepreneurs and cadres. As the scale of private business becomes larger, economic and administrative resources under the bureaucrats' control become more crucial for entrepreneurs. In this situation, ex-cadre entrepreneurs, having political connections, achieve significantly higher profits compared with non-ex-cadre entrepreneurs.

The findings in this paper also demonstrate that entrepreneurs' profits have a positive correlation to their self-reported degree of political participation. This implies that entrepreneurs used their political connection to advance their business interests. The findings reflect that bureaucrats are supportive of successful entrepreneurs in order to their own interests, such as taxes and personal gains.⁵³

The rise of private business in the second stage brings interpenetration of cadres' political power and newly growing entrepreneurial power. This interpenetration is likely to contribute to evolutionary changes in China. The persistent importance of political connections provides cadres with benefits in market transformation, which reduces potential discontent on their part.

The paper challenges the notion that an entrepreneur's interests are always at odds with those of a privileged party elite. The entrepreneurs' alliance with the state may be beneficial to their businesses. What is worse is that the entrepreneur/state alliance may delay the political reform that China so badly needs. As White et al. argue: "So long as these [private] associational sectors remain so deeply enmeshed with and dependent on the state, they will be an obstacle to political reform; the gap between them and the possibilities for peaceful and stable political transition will be weakened."⁵⁴ Rent-seeking behaviour has become the most important reason for business success. If such a situation continues, Chinese market development and political democratization are likely to slow down.

Notes

- * We are grateful to the Universities Service Centre for the data used in this study.

1. *Getihu* refers to private and household small businesses that employ fewer than eight people while “private enterprise” refers to firms that hire more than eight people.
2. Akos Rona-Tas, “The First Shall Be Last? Entrepreneurship and Communist Cadres in the Transition from Socialism,” *American Journal of Sociology*, Vol. 100, No. 1 (1994), pp. 40–69.
3. Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley: University of California Press, 1999), p. 137; Marc Blecher and Vivienne Shue, *Tethered Deer: Government and Economy in a Chinese County* (Stanford: Stanford University Press, 1996).
4. Jean C. Oi, “Fiscal Reform and the Economic Foundations of Local State Corporatism in China,” *World Politics*, Vol. 45, No. 1 (1992), pp. 99–126.
5. Qinglian He, *Xiandaihua de xianjing: Dangdai Zhongguo de jingji shehui wenti* (Pitfalls of Modernization: Contemporary Chinese Economic and Social Problems) (Beijing: Jinri Zhongguo chubanshe, 1998), p. 568.
6. Jane Duckett, *The Entrepreneurial State in China: Real Estate and Commerce Departments in Reform Era Tianjin* (London: Routledge, 1998).
7. Victor Nee, “A Theory of Market Transition: From Redistribution to Markets in State Socialism,” *American Sociological Review*, Vol. 54, No. 4 (1989), pp. 663–81; Kate Xiao Zhou, *How the Farmers Changed China: Power of the People* (Boulder: Westview Press, 1996).
8. Nee, *ibid.*, p. 671.
9. Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper, 1942).
10. Duckett (Note 6), p. 570.
11. Fangming Zhu et al., *Siyou jingji zai Zhongguo* (Private Economy in China) (Beijing: Zhongguo chengshi chubanshe, 1998), p. 78.
12. Zhang Houyi and Ming Lizhi (eds), *Zhongguo siying qiye fazhan baogao* (Report on the Development of Private Business in China) (Beijing: Shehui kexue wenxian chubanshe, 1999).
13. *Renmin ribao* (People’s Daily), 16 March 1999.
14. In 1992, around 100,000 cadres in the party-government organizations started their own businesses. See Yan Zhou, *Zhongguo zhongchan jieji: weilai shehui jiegou de zhuliu* (Middle Class in China: Mainstream of the Social Structure in the Future) (Beijing: Zhongguo jihua chubanshe, 1999), p. 31. At the local level, regulations were made for cadres in the party —government organizations to start private businesses with a condition that they received no, or only a portion of their salaries but retained their posts. For example, Shandong province made a regulation that cadres in the party-government organizations, with the agreement of their work units, are able to engage in private business. While so doing, cadres receive 60% of their salaries. See Wang Linchang, *Feigongyouzhi jingji guanli* (Economic Administration in a

- Non-public Sector) (Wuhan: Wuhan daxue chubanshe, 1998), p. 119. This kind of regulation relieves cadres of risks in starting their own businesses.
15. Originally we included a dummy variable of cadres in enterprises. Later, we excluded it as the coefficient of this variable was not significant.
 16. On the influences of ambivalent state policies on private business, see Linda Hershkovitz, "The Fruits of Ambivalence: China's Urban Individual Economy," *Pacific Affairs*, Vol. 58, No. 3 (1985), pp. 427–50.
 17. Susan Young, *Private Business and Economic Reform in China* (Armonk: M. E. Sharpe, 1995), pp. 14–17.
 18. Duckett (Note 6).
 19. Gerald Segal, China: Who's in Charge? World Link September/October 1995, Internet.
 20. Personal interview with Shen Fushou and Qiang Guoxiang, real estate developers in Shanghai, in 1997.
 21. Jane Duckett, *The Entrepreneurial State in China: Real Estate and Commerce Departments in Reform Era Tianjin*.
 22. He (Note 5), p. 76.
 23. Ibid.
 24. Ibid.
 25. Segal (Note 19).
 26. Anne F. Thurston, *Muddling Toward Democracy: Political Change in Grassroots China* (Washington, DC: United States Institute of Peace, 1998).
 27. Ole Odgaard, *Private Business in Rural China* (Avebury: Ashgate Publishing Company, 1992), p. 442.
 28. Odgaard, *ibid.*, pp. 194–96; Christopher Earle Nevitt, "Private Business Association in China: Evidence of Civil Society or Local State Power?" *The China Journal*, No. 36 (July 1996), pp. 25–43.
 29. See Ole Brunn, *Business and Bureaucracy in a Chinese City* (Berkeley: University of California Press, 1993), pp. 116–18. Self-employed labourers become members of the self-employed labourers' association when they register as self-employed labourers. Starting from the grassroots, the self-employed labourers' association was organized at the national level in 1986. There was no national level organization for private business associations by 1998. To establish a private business association, permission from the Industry and Commerce Bureau is required. See Wang (Note 14), pp. 137–48. On the study of these associations, see Jonathan Unger, "'Bridges': Private Business, the Chinese Government and the Rise of New Association," *The China Quarterly*, No. 147 (September 1996), pp. 795–819; Nevitt (Note 29); Margaret Pearson, *China's New Business Elite: The Political Consequences of Economic Reform* (Berkeley: University of California Press, 1996).

30. See David Wank, *Commodifying Communism: Business, Trust, and Politics in a Chinese City* (Cambridge: Cambridge University Press, 1999).
31. Thomas G. Rawski, "China's Move to Market: How Far? What Next?" p. 10. This is a paper presented at a Cato Institute Conference, Whither China?: The PRC at 50, held on 29 September 1999.
32. *Nanfang ribao* (South China Daily), 12 January 1996.
33. Personal interview with Mu in summer 1998, Beijing.
34. Interview with Yang Dalun, the vice-president of Everbright Bank, Shenzhen, June 1999.
35. Rawski (Note 31).
36. *Ibid.*, p. 6.
37. J. Li, "Economy Good, Despite Severe Crisis and Flood," *China Daily*, Beijing, 4 March 1998.
38. Jane Macartney, World Bank Urges Less Intervention in China Markets, C-reuters@clari.net (Reuter /) Thu, 18 Jan 1996 4:10:20.
39. He (Note 5), p. 53.
40. Personal interviews with staff of Finance Ministry and Chinese People's Bank, Guanghua Bank in Beijing and Shenzhen, 1998 and 1999.
41. James M. Buchanan, Robert D. Tollison, and Gordon Tullock (eds), *Toward a Theory of the Rent-seeking Society* (College Station: Texas A & M University Press, 1980).
42. Buchanan, *ibid.*, p. 9.
43. Jagdish N. Bhagwati, "Directly Unproductive, Profit-seeking (DUP) Activities," *Journal of Political Economy*, Vol. 90, No. 5 (1982), pp. 988–1002.
44. Personal participation observation in Shenzhen, China, 30 December 1994.
45. I. Johnson, "China's Wu Looks to Derail WTO Talks: Fiery Minister's Internet Edict Hampers Negotiators' Delicate Efforts," *Asian Wall Street Journal*, Hong Kong, 7 (Month) 1999.
46. Oliver E. Williamson, *Economic Organization: Firms, Markets, and Policy Control* (Brighton: Wheatsheaf Books, 1986), p. 565.
47. Anita Chan, "Revolution or Corporatism?" *Australian Journal of Chinese Affairs*, Vol. 29 (January 1993), pp. 31–62.
48. He (Note 5).
49. Death Sentences for top government officials in the 1990s: Yan Jianhong, Manager of International Monetary Trust, Guizhou; Zhang Deyuan, Manager of International Monetary Trust, Hunan; Chen Ming, General Manager of Beijing Electricity and Power Company; Guo Ziwen, General Manager of Chinese Coal Sale Company; Lin Guodi, Bureau Chief of Machinery Industry, Hunan; Xie Heting, General Manager of Tian Nong Corporation, Guangdong; Dai Tianming, Executive Manager of Investment Bank, Hunan Branch; Liu Yiqing, Executive Manager of Investment Commercial Bank, Hunan Branch;

- Hu Jianxue, Party Secretary, Tai'an city, Shandong province (sentence suspended for two years); Chen Tongqin, Party Secretary, Zhanjiang city, Guangdong province (sentence suspended for two years).
50. This is from Lin Yuanzhi, *Cong yi qiange anli kan fubai* (See Corruption from One Thousand Cases). CND, 22 October 1999. <http://www.cnd.org/HXWZ/>
 51. Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).
 52. Gerald P. O'Driscoli Jr., Kim R. Holmes, and Melanie Kirkpatrick, "Economic Freedom Marches On," *Wall Street Journal*, 30 November 1999.
 53. In the 1990s, private business became a lucrative source of revenue for local government. It is reported that taxes collected from private enterprises soared 23% to RMB 44.1 billion between January and October in 1997, whereas in the same period, taxes from collective enterprises rose only 3% to RMB 100.1 billion. See FBIS-CHI-98-042, Beijing Xinhua, 11 February 1998. Jonathan Unger and Anita Chan argue that local governments favour large-scale private enterprises as these have strong potential to boost the local economy. Jonathan Unger and Anita Chan, "Inheritors of the Boom: Private Enterprise and the Role of Local Government in a Rural South China Township," *The China Journal*, Vol. 42 (July 1999), p. 65.
 54. Gordon White and Jude Howell, et al., *In Search of Civil Society: Market Reform and Social Change in Contemporary China* (Oxford: Clarendon Press, 1996), p. 216.