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**From Player to Referee:  
The Emergence of the Regulatory State in China\***

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**Xiaobo Lu**

## **I. Introduction**

The political and economic history of the past two decades poses an interesting yet unanswered question that looms large: Can economic development be achieved and sustained under a non-democratic regime? With this broader query in mind, I will attempt to address some of important aspects related to the relationship between political regime (change) and economic development by examining China's reform in recent years.

The departing point of this paper is that while there is a lack of reforms in political regime (e.g. representative body, political freedom, etc), China's state institutions and governance have undergone changes. These changes are crucial in inducing economic performance and on the direction of political regime transition. Among many such changes, regulatory institutional change is one of the most significant institutional changes that are responsible for the success and failure of economic development. I call it the emerging regulatory state in China. In this paper, which is part of a larger project, I will lay out what the regulatory reforms have been in China and challenges they face. I will explore to what extent government regulation affects economic performance and transition. By doing so, the paper will attempt to address the question of how important institutional building (as exemplified by regulatory institutional building) is in the transition to a market economy.

The trajectory of changing role of the state in the early reform period (early 1980s through mid-1990s) suggests a pattern of an authoritarian state actively involved in economic development. It was dictated by the principle set forth by Deng and Jiang that "development is the hard truth" "all work should be centered on development". By itself, such a developmental state is nothing new—after all, other East Asian economies such as Taiwan, South Korea, and to a certain extent, Japan, have gone through similar path. However, there were some qualitative differences between the East Asian developmental states and the Chinese one. For one, the state was the player, not just a bystander of the private sector, promoter of trade, and guardian of the market. The state not only led the market, it created the market. The historical legacy of a non-market economy and all encompassing state was another major variant of the developmental state as it existed in reform China.

The early success of the Chinese reform has been attributed, convincingly I think, to the decentralization that had given much fiscal incentive to local governments in engaging in economic development. The role of local government in promoting economic development was regarded as a key in China's success in maintaining high economic performance. The economic success in China has been attributed to the growing fiscal incentives for local governments to invest and lead the economy. Both the local state corporatism model (Oi, 1995, Nee, 1997) and the "federalism Chinese style" argument (Weingast 1997; Montinola, Qian and Weingast 1995; Li 1998) contend that under the

decentralization, particularly of fiscal power, China was able to achieve high economic performance. The political consequences of such decentralization are seen as enhancing the bargaining positions of local government via-s-via the central government, forcing the latter to recognize a de facto federalism. A wave of research projects has studied rural TVEs or fiscal reforms, which can effectively inform us about the local government role in economic development. Literature on conflicts or divergence of interests between central and local state grew (Breslin, 1996; Blecher and Shue, 1996; Jia and Lin, 1994). Others have highlighted the entrepreneurial role of local governments (Blecher, 1991; Duckett, 1998).

But the model of developmental state à la China has run into serious problems as its counterparts in other newly industrialized economies. This happened in China as the reforms were expanded and the market has slowly emerged as the dominant form of the economic activities. Starting in the mid-1990s, the Chinese reforms entered what I call “the reform deepening stage” where the existing emphasis on the developmental role of the state had rendered highly problematic. A developmental state could be, for example, highly predatory even as it was to reduce poverty and improve living standards of the population. In fact, studies have shown that it was precisely due to the pressure of social and economic development that the state, usually at its local level, had acted in a predatory manner vis à vis local population (see Bernstein and Lu, 2000, 2003). Decentralization, another pillar of the early success, also brought about distortions and failures. Scholars, for example, highlighted the weakening of central fiscal power as highly problematic for the reform (see Wang Shaoguang, 1997; C. Wong, 1997), and the ever-diminishing share of central fiscal revenues and to the incentives for local governments to engage in wasteful and irrational investment decisions. Others have pointed to the entangled, often inefficient, relationship between local governments and enterprises. Unlike the local corporatism argument, this view pays attention to the problem of existing fiscal system and to the long-existing problem of *zhengqi bufen* or non-separation of government and enterprises. It was argued that to the extent that fiscal reforms have been implemented to separate the government from enterprises local officials stand to be major losers (Whiting 1998).

Realizing the pitfalls of the reform policies that have dominated the early reform period, the Chinese leadership, particularly Zhu Rongji and his associates, began a series of reforms that were aimed at correcting the early mistakes and bringing about further changes that would guarantee continued success. Beginning in the mid-1990s, there has been a gradual yet often unnoticed change in the role of the state and its governance, a process of which I call, the “emergence of the regulatory state under an authoritarian regime”.

The rise of the regulatory state is again nothing new. Since the 1980s, there have been increasing pressures in countries in many part of world to deregulate and engage in regulatory reforms. Reasons for this trend are many: the influence of the neo-liberal economic doctrines as incarnated in the form of Reaganomics, the creeping globalization that force the hand of countries, the bottlenecks and difficulties created and faced by the developmental states, etc. Regulatory reforms, or the rise of the regulatory state, were

launched in industrialized countries in Western Europe, transition economies of Eastern Europe, as well as newly industrialized economies in Asia.

The emergence of the regulatory state in China is unfolding against a different backdrop. It is in part a necessary adjustment to the new challenges of a nascent market economy as well as finding a way to manage a political economy without rapidly changing the regime. It is, to a large extent, a gradual but fundamental process of change. For a country like China where market institutions are weak or non-existent, building an effective regulatory regime is as important as the rise of the market itself. As the President of the World Bank put it to a Chinese audience, “it would be crazy to build your stock market before you have effective regulation, effective reporting and effective governance. What you need is a strong, independent regulatory system.” (Wolfensohn, 2002). It is clear that the Chinese leaders have heeded the advice from Mr. Wolfensohn.

A quick comparison with other states, both historical and contemporary, China will yield interesting characters in its path of regulatory reforms. As in other post-state-socialist transition countries, China has a weak or non-existing private sector to begin with. There were no market institutions as the transition began. The state apparatus was huge, yet ill-prepared for the task of regulation of the marketplace. But unlike its former Communist counterparts, China did not dismantle the state and its power. Nor did it privatize the state sector en masse. The emergence of the markets and private sector was gradual and controlled. Compared with its nearby East Asian newly industrialized economies, China shares some significant aspects of the developmental state model of political and economic change: an active state was committed to and led the development efforts while keeping civil society at bay. This success of the East Asian NIEs has given the Chinese leaders much inspiration, if not blueprint, for reform. But in one crucial aspect China differs dramatically from these early success stories: the market and private sector. No matter how weak the society was and how interventionist the state was in EA countries, there was always a strong private sector and the market never disappeared as in China. In China, the challenge is as much as creating the market than helping and maintaining order in the marketplace.

With more matured capitalist economies, the Chinese case is also comparable. But such a comparison necessarily takes on a historical dimension. The rise of the regulatory state in the U.S., for example, was also a response to some negative developments that, without checking, would have hurt the healthy growth of capitalism, such as trusts and monopolies, fraudulent claims by producers, fake products that harmed consumers in the early 20<sup>th</sup> century and throughout. It took a century for the US to fully develop its regulatory regime, which is still under constant reform. For other industrialized countries, regulatory reforms came even later in the last few decades of the 20<sup>th</sup> century. In the U.K., it was yet another model of change of the role of the state in the economy. Similar to China, U.K. had chosen nationalization as a viable way to develop economy since the early 20<sup>th</sup> century till the 1970s. Even though British private enterprises were numerous and vibrant, large industries especially those of natural monopoly were controlled by the state. Regulatory institutions were weak. Only after the de-nationalization drive began under the Thatcher government in the late 1970s, did the

regulatory state emerge in the UK. So as is the case now in China, Britain's regulatory reforms were launched as a result of the de-statization of the economy.

Thus the rise of the regulatory state in China is both logical and historically comparable to the experiences of the early comers. However, what China faces today is a markedly different environment. The emergences of capitalism and regulatory state are both confined into a timeframe of years not decades or centuries when the early comers did it. China, in another word, can't be expected just to be compared with historical experiences of others and contend with what it has been able to accomplish in a relatively short time, but has to face challenges of implementing change in a different world today.

The emergence of the regulatory state bears great significance for the future political economic development of China. As an economic issue, whether the government will be able to manage an increasingly free and open market economy depends on how the state learns to be a fair and just "referee" of a new game of capitalism. Politically, the rise of the regulatory state could result in governance change under a non-democratic regime, which, in turn and in the long run, could lead to full opening of the political process. Already, there are signs that the emerging regulatory state (reform) has brought about changes, limited as they are, in ways how government agencies and agents behave. One example is establishing the practice of public hearing in regulatory matters such as utility rate change and pricing of railways and airlines. Transparency in governance is a novel idea to Communist cadres who were used to work in a black box. Being a regulator of a market economy, even short of democratization, has made government work in some ways a bit more open. Another instance is subtler—the emerging regulatory state began to make the concept (not yet principle) of "limited government" seem less abstract and foreign both for government officials and ordinary citizens. As my research shows, the idea that government's power is not boundless and that government agencies and agents can be held accountable legally if they step over the boundary of the law or rules is beginning to take hold. A related but different aspect is the "procedural consciousness" or what Charmers Johnson called "rule culture" that lacked among Chinese bureaucrats. To say that some government agency or agent can be sued in court because of procedural violation even as the consequence of its actions is for the welfare of the society would have been completely nonsense to both those who govern and the governed in China. Students of Chinese history and culture would agree that the idea of "limited government" and "procedural consciousness" had never been a dominated Chinese political thinking. Nor had they been strong in the Chinese political culture. But it seems that as the new role of regulation is being learned, procedural consciousness is also gaining space in the institutional and individual minds.

The emergence of the regulatory state in China, therefore, is significant not only for the examination of the past and present political economic development in China, it is also important for understanding possible future political change in China. It is not just a story and analysis of Chinese bureaucracy, but also and more significantly, a search into scenarios of transition of the Chinese political regime.

As an academic inquiry, this study raises and attempts to answer both empirical and theoretical questions. These include, on the empirical level, the questions of whether is indeed such a change from “player” to “referee” of the state in China; how the regulatory state emerged; how it has affected the behavior of the Chinese bureaucrats and thus governance; and how it has affected the behavior of economic and social actors and thus economic development. On the theoretical level, the questions raised hereafter include: Why do regulations and regulatory state emerge? Is regulation by the state necessary and good? Why should countries have it? What does the emergence of the regulatory state mean for the state-market and state-society relations?

## II. Conceptual Issues in General and the Chinese Context

What is “regulation”? In its broadest sense, regulation is any attempt by government to control the behavior of citizens, corporations, or other social entities. But such broad definition does not help in our analysis of the kind of state regulation we are interested in. If one perceives from a public administration perspective, regulation is “to assign a government agency the responsibility of writing rules constraining certain kinds of private economic decisions, using a quasi-judicial administrative process to develop these rules.”<sup>1</sup> From the perspectives of political economy or public policy, regulation can be defined as public policies explicitly designed to govern economic activities and its consequences at the level of the individual, firm or sub-government units. In the context of a transition economy like China, we need to distinguish regulations in two different economic settings: the central planning or command economy, and the market or capitalist economy.<sup>2</sup> Regulation in a central-planning economy is different from regulation in the market economy in several fundamental ways—its *rationale* (the state is the best actor, not the second best, in economic activities), *goals* (efficient allocation of resources, production of goods, and social equality, rather than remedying market failure and externalities), *instruments* (policy statements and direct control, rather than laws and incentives), and *scope* (almost all economic activities, rather than only responding to incomplete market and information). As a displacement and replacement of the market, central planning represents an extreme form of government regulation. It had some features of regulation in a market economy such as price control and entry regulation. But since the economy under central planning is almost totally run by administrative means and by administrative agents, regulation under central planning is but an extension of public administration. The only government regulation that both the central-planning regime and a market economy share, insofar as China is concerned, is the work safety and health regulations. As early as in the 1950s, the State Council issued “Factory Safety and Health Rules and Procedures” (1956), “Technical Procedures on Safety in

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<sup>1</sup> See Roger Noll, *Regulatory Policy and the Social Sciences*, University of California Press, 1985, p. 3.

<sup>2</sup> When I mentioned that my research focuses on the emerging regulatory regime in China at a gathering of research fellows at the Hoover Institution, a distinguished economist on regulation commented with amusement, “I thought China has always had regulations! Don’t they have too much of it?”

Construction Industry” (1956), and later, “Rules on Enhancing Production Safety in Enterprises” (1963).

The regulatory function of the state was actually quite weak under the command economic system precisely because of the over-development of redistributive and mobilization functions of state and the underdevelopment of the regulatory function. The very foundation of regulatory state—rule of law—did not exist. A redistributive state regulates the economy and society not through statute laws and regulations but administrative orders and decrees.

There are two basic kinds of regulation: economic and social. Social regulation is about regulating risks, while economic regulation is about monopoly and market entry barrier. It does not regulate a certain sector or industry but overall effects of production and consumption. The traditional justification for intervention by regulation is failure in the economic marketplace. But the pattern has undergone considerable changes in the last few decades (John Francis, 1993). In social regulatory regimes, there is considerable variation in the extent to which the state relies on market strategies and self-regulation. China, due to its lack of mature market institutions and weak private sector, relies more on the state and less on market strategies and non-state organizations.

In the west, it has been generally agreed that government has to accept responsibility for preventing or minimizing hazards to human health and the environment. However, due to the high cost of compliance and increased bureaucratic red tape, it had met great resistance from corporate interests and provoked constant criticism from proponent of regulation. In China, this proves less a problem as the nascent marketplace is more chaotic.

In China, as in some European countries, the rise of regulatory regime involved both regulation (new regulatory design)—enhancing the regulatory capacity and effectiveness in social regulation, which may involves expansion of government regulatory power; and deregulation (liberalization)—government deregulates industries once regulated with public ownership and the state acting as a manager and regulator at the same time. Deregulation transfers the role of the state from the manager-regulator to a regulator. In the case of economic regulation, market activities can be regulated only in societies that consider such activities worthwhile in themselves and hence in need of protection as well we as control (Majone, 1996: 50). Some scholars call this situation “re-regulation” because it is a replacement of one mode of regulation—public ownership, by another, statutory regulation (Majone, 1996: 54).

A proper balance between re-regulation and deregulation is necessary. In a market economy, government must show credible commitment to property rights protection. Economic agents take important clues from such institutional arrangements as legal and regulatory regimes including legislation, rule-making, and enforcement. “Excessive regulations may create a generalized drag on all businesses or may favor some businesses over others. Poor regulation not only adds to the costs of doing business, but also increases uncertainty about the returns from investments and individual transactions”

(Stone, Levy, and Paredes, 1996:106). One vital role that government must perform in any economy is establishing the rules of the game that will govern both the interactions among private parties and between private parties and the government (Stiglitz, 1994: 257).

Thus, in regulatory reforms as part of the rise of the regulatory state in China, deregulation, which should be mostly in the realm of economic regulation, involves reducing the government control over who and how to enter the marketplace (through such means as reducing the number of permits and licenses issued by the government), while re-regulation, which should be mostly in the realm of social regulation, involves enhancing and improving government's monitoring and correcting misbehavior and misinformation in the marketplace (through such means as ex facto ante and post facto inspections).

### **III. What's Behind the Rise of the Regulatory State?**

Why did regulatory state emerge? There are two basic theories: first, normative theory of regulation—regulation is created because of market failures. Regulations are aimed at correcting market failure and promote public interests; Second, positive theory of regulation (or economic theory of regulation) such as George Stigler—regulations are created because the demands from industries that have vested interests.

The first category of theories also suggests institutional imperatives for successful economic development. This school of thoughts tends to place greater emphasis on the needs of the public interest to correct market imperfections and externalities (monopoly tendency, external effects, and imperfect information). Douglas North and others call this the “public interest paradigm” on regulation. Regulatory agencies and agents seek to maximize social welfare or the public interest. The functional rationales behind such institutions include, the need for expertise in highly complex technical matters; rule-making and adjudicative function that is inappropriate for government departments, agency's separateness from government is useful to free public administration from partisan politics; agencies provide greater policy continuity than political executives (Majone, 1996: 49). These functional explanations of the rise of regulatory regime in former socialist economies where many factors are at work are less convincing. In this paper, I will consider the emergence of the market, public interests, interests of bureaucrats, politicians, consumers, businesses (those who are in and those who are outside), policy entrepreneurs, and ideas.

The other category of theories focuses on the interplay between organized interests, usually private businesses, and “regulators”. Economic critiques of regulation (many to be found in the public-choice tradition) usually belong to this genre. To them, regulations set the rule of the economic game and thereby the incentives for actors (Alston, Eggertsson, and North, 166). Scholars such as Stigler and Olson see the source of regulation in the demands derive from special interests who often “capture” regulatory agencies later. So to them, it is not the supply side of the government, but the demand

side of interest groups who are responsible for more regulation. It is a theory of wealth transfer demanded by certain producers (Mackey, Miller and Yandle 1987). Regulators behave in a way to maximize their self-interests. In this view, regulatory agencies and regulators are often influenced, and even “captured” by the interests they are supposed to regulate.

Among this kind of theories, one is more relevant to the Chinese case: namely, “the bureau as enterprise” theory –which has two variants, “the budget-maximization theory” (Wildavsky, McKean) and “the venal administrator theory” (Schwartz 1959). The former suggests that government agencies tend to focus on budget maximization, and the latter argues that agencies are operated to maximize the permanent income of administrative heads. In the latter, another argument is that administrators seek to advance their career goals through the vehicle of regulatory agencies. Thus regulatory agencies are vehicles for obtaining better employment in the private sector.

### *Public interests and the marketplace*

The most important factor for the emergence of the regulatory state is the development of the market economy. During the Maoist central-planning era, the state’s role was simple—it regulated (read controlled) on *all* aspects of social and economic life and needed not to distinguish among them. It was, at its height and pure form, owner, player, referee, and coach all combined in one.

As the markets emerge, the commitment from the government to guarantee property rights becomes crucial. The Chinese state started retreating from being a player and owner. But it was not enough. The state also had to be a good coach and referee in the new game of the market economy. The Chinese experience clearly indicate that first and primary impetus for change came from the needs to address the new problems that have arisen from the conditions related to the marketplace.

### *Business and Bureaucratic Interests*

How significant are the interests of various actors in the emergence of the regulatory state? Some regulatory economists have argued that the reason why regulation by the state emerge lies in the vested interests of those who are already in the marketplace and want no competition from new comers. They want to enjoy rents created by the regulated market, hence push for more regulations by the state. They are so powerful that they often “capture” the government agencies that are supposed to regulate them. In countries where the private sector is strong and business interests are powerful, such arguments may work. But in China large firms have been always owned and operated by the state. Private firms are generally weak, and until recently, small in size. Large state firms (such as power companies and telecommunication companies) do have a say in shaping government regulatory policies. But their influence is limited. Certainly the ‘capture’ theory of regulation does not work in the case of China.

The influence of vested interests is not insignificant, though. Contestation of interests over regulation and regulatory powers come from a difference source—from within the bureaucracy. In almost every case of the institutional reforms of government regulatory agencies there has been intense lobbying based on a ministry's interests.

The argument that reforms were at least in part driven by sectoral interests of government agencies may also explain why the resistance from bureaucrats was not as fierce and persistent as one would have predicted. Even though the “buy-off” theory of economic success (see Yingyi Qian on anonymous bank deposits and David Li on corruption) is not entirely convincing, it does provide some interesting perspective on how the success was achieved in the early period of the reform despite of possible bureaucratic resistance. In the reform-deepening period, the “buy-off” is done with different enticement package in which regulatory authorities is a significant part (see Xiaobo Lu on rent-opportunities created by the increasing regulatory power in government agencies). I am not suggesting, though, that this is an intentional and conscious scheme on the part of the leadership to reduce the resistance from the officialdom. But because that it is in the interest of government officials to see their power (hence rent-opportunity) not being reduced while their control over resources as an owner and player decreases, they have not put up a fight as long as they are given more regulatory authorities.

In the process of institutional change of an emerging regulatory state in China, some regulatory institutions are created anew, while others are a result of transformation from pre-existing ministries that managed production. It involves many actors that have some interests in the changes: central ministries, businesses (both SOEs and non-state), consumers and local governments. In this process, some bureaucratic agencies are winners, some losers. There has certainly been resistance from the bureaucracy to regulatory reforms due to their potential threat to their power. But not all bureaucrats have resisted because the incentives for them to support the reforms. While many government agencies have lost or are losing power due to the separation from enterprises, there are winners among them as well. The winners are agencies with more regulatory power and losers are “superior responsible agencies”. In many cases, existing bureaucratic agencies lose their supervisory-redistributive power over enterprises, but they also found new regulatory power to recoup the losses. So, what happened in the reform is not a simple loss of power by one player—the bureaucracy, but a shift of power among various agencies and segments of bureaucracy.

The basic tenets of the central planning system eliminate any meaningful market competition. The state, through its agents, the communist cadres, ran the entire economy. The transition from central planning to the market involves institutional change in bureaucratic organization and its management of the economy.

The appearance of the market, like a sport game, must have multiple players and requires a referee. Players play by the rules of the game, and the referee makes sure that rules are abided by. To make a meaningful game, players must have more or less same level skills and attributes. It would be ridiculous to have a professional basketball team

play, say, a high school team. In the transition economies, the government was initially in a dominant position in the new game of market competition, not because it was a good player, but that it was both the player and referee, with a rulebook not fitting for the game. The reforms reduced the involvement of the government as a player, while the rulebook was being rewritten. It is a new ball game.

Still, why should those individuals in the government—cadres—give up as a player? As Douglas North points out, a regulator “is an agent and has his or her own utility function, which will dictate his or her perceptions about the issues and therefore will be affected by his or her own interests” (North 1990: 58). The key is the rent opportunity that official positions afford in transitional regimes. To these cadres, probably the best scenario is (A), i.e. the bureaucracy being both the player and referee. That provides the best opportunity for creating and harvesting rents. Scenario (C) is the second best, in which the bureaucracy is mainly of a rule enforcer, because it still provides them with high rent opportunity. To the bureaucracy under reform in a transitional economy, the worst outcome would be (B), where it would lose potential rents afforded by being in a position with asymmetrical power (i.e. referee) even though it is still a player in the game. Bureaucrats loathe at the possibility of (D), which means they would be totally out of the game. They are neither economic agents nor regulators of economic activities.

To investors and the economy, the preference is quite different. Credible commitment from government is an important factor in their investment decision making. Although they prefer less government intervention (D or B), the nature of the market requires certain rules that all parties can abide by. A sport game must have a referee and a set of rules. The referee must show his/her commitment to make fair judgment according to the rules. As Stiglitz pointed out, one vital role that government must perform in any economy is to establish the rules of the game that will govern both the interaction among private parties and between these private parties and the government (Stiglitz, 1994: 257). In mature market economies, such a referee role can be performed by non-government bodies such as trade groups. In transition economy where autonomous social groups are less developed, the rule-enforcement or referee role is largely belated with the government. So to have a competitive and fair game, a fair and able referee is necessary (Scenario C).

Communist cadres naturally inclined to resist the reforms in which they were likely to lose the control over resources. But such resistance could be prevented or contained by letting them find other opportunities to create and harvest rents. In China, the “dual price” system provided, in the mid-1980s, the opportunity for cadres to seek rent by speculating goods at price differentials of the official and market prices. In the meantime, more and more government agencies sought to operate their own for-profit companies as the markets began to emerge. At times, the government even encouraged cadres to “take a plunge” into the sea of business. Scholars have called this “entrepreneurial state” (Duckett 1998, Blecher 1993). On whether to allow government agencies to engage in for-profit activities, the government sent out confusing signals. It

actually flip-flopped its policies. Although resistance from cadres was reduced, the discontent from private citizens increased.

The case of The State Food and Drug Administration (SFDA) is the most illuminating. SFDA was first established in 1998, as a part of a major overhaul of the government function and structure. By the mid 1990s, China's food, health products, cosmetics, and drug markets had flourished and chaotic. Fake drugs, fraudulent claims of effectiveness of health products and cosmetics, low quality health and drug products plagued the market. Increasingly common were food poisoning incidents. The efforts to build an integrated and effective food and drug regulatory regime were clearly initiated because of public interests in improving safety and healthy market development. In a non-democratic system, the role of leaders cannot be underestimated. According to officials at the food and drug administration, it was Zhu Rongji who requested the establishment of a strong, integrated regulatory agency modeled after the FDA in the US. As a premier, his personal role was significant in the development of the regulatory institutions in the 1990s.<sup>3</sup> Originally Zhu Rongji had asked for an agency that would have both food (health products) and drug regulatory powers. But the final plan in 1998 dropped the food and cosmetics regulation from the new agency's mandate as a result of, according to one official as SFDA, resistance from the would-be new agency staff for the reason that it would not have know-how and personnel to deal with such a broad mandate. Just drug regulation alone would have their hands full.<sup>4</sup> One could argue that in this instance the new agency, State Drug Administration (SDA), was born of mainly with public interest considerations. That it did not take on the task of regulating the food and health products, which, in hindsight, would have been extremely difficult, was much based on public interest consideration than own agency interests. The latter, of course, is not to be completely ignored specially as the new agency takes on a life of its own and grows up.

In its short life of five years, the SDA had proved to be one of the "pockets of efficiency" in the Chinese bureaucracy by 2003. While the drug market had seen a dramatic improvement, the food and health product markets continued to be plagued by hazards. The calls for a more effective regulation could be heard from many quarters. The question was how and who. It was in this process of reform of regulatory institutions where the vested agency interests came in to play.

It seemed little disagreement that China's overall regulation of the health product market in its broadest definition had been highly fragmented, and that it should be somehow become more integrated. The fragmentation not only manifested itself at the horizontally—among different ministries and agencies, but also vertically—among various levels of government. Even though the nature of food chain makes a single-agency regulation almost impossible, some coordinating body that takes lead among agencies involved is necessary.<sup>5</sup> If integration was to occur, who was to be in charge?

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<sup>3</sup> Interviews, Beijing, October 2003.

<sup>4</sup> Ibid.

<sup>5</sup> Even in the US, FDA is not the only agency in charge of food regulation.

Proposals were drafted by different ministries and NPC delegates. Intense lobbying also followed.

The Ministry of Health (MOH) proposed that SDA be merged into a new agency under MOH and be the regulatory arm of the new agency with broader mandate of health product regulation.<sup>6</sup> This proposal, reflecting the longtime view of MOH that food and drug regulation should be under its jurisdiction, was clearly based on MOH's own interests. Interestingly, one argument used by MOH was that FDA in the US is under the Department of Health and Human Services despite the fact that FDA is an independent agency mandated by the Congress even though administratively it is under DOH.

In a proposal issued by the China Agricultural and Workers Party, which is mainly comprised of medical professionals, a similar argument was advanced. It wrote, "MOH is a neutral supervisory department. To establish a food safety agency under the MOH is an international trend. In order to meet the needs of food safety and adopt the standard practices of the world, there should be a national level food safety administration under the MOH."<sup>7</sup> This is an interest group of medical professionals, many of whom have close ties with the officials at MOH. Some MOH officials are members of this party. The strong advocacy of enhancing the power of MOH can be detected throughout this document. One suspects that it was written with cooperation from MOH officials, if not by themselves.

But the State Council overruled the proposals that would have given more power to MOH and put the food and drug administration under MOH. Even though it was not so keen on getting the food and health product safety regulation functions, SDA clearly did not want to subject to MOH authorities. Being a vice-ministerial level agency, it resisted the proposal to put it back under the ministry of health. It did its share of lobbying. Compared with MOH, it had several advantages: it had the support of many non-government experts who saw MOH as an ineffective regulator and SDA as a better choice. It also had the model of an all-powerful and independent FDA, on which the original reforms were based, on its side. The success of the SDA, limited as it may have been, convinced the decision makers at the Office of Organizational and Personnel Restructuring. The final decision to shift powers of the health products regulation and "coordination of food regulation among various agencies" to SDA may also reflect distrust of old ministries ability to take on new authorities.

### *Ideas*

Ideas matter in institutional change. A key question for devising a rational and effective regulatory regime is how to regulate: Where regulatory authorities should be—at the central or local level? Who should be the one that regulates—the state through government regulation or society through self-regulation? Should the regulatory institutions be integrated or dispersed?

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<sup>6</sup> See 《财经》 *Caijing*, 2003.3.6.

<sup>7</sup> 中国网 2002.3.3. ([www.china.org.cn](http://www.china.org.cn)).

In the Chinese reforms, eventual goals of the reform are often construed and propagandized as guiding principles. Despite that they often are vague and even unattainable (such as the idea of “primary stage of socialism” or “socialist market economy with Chinese characteristics”), these ideas or principles are important in influencing the course and pace of change at a given stage of development. The process of the rise of the regulatory state has been influenced by three important principles: (1) “from player to referee”, (2) “small government, big society”, (3) “the rule of law”. Even though these doctrinal principles have never been raised together explicitly as interrelated goals of governance reform, they have been at different times put forth by the leadership as guidelines for administrative and economic reforms. Lacking is the principle of cost-effective consideration. It seems regulatory costs—both on the regulator and the regulated (i.e. the state and the economic actors)—are high in China and it has not been given enough attention.

### Society self-regulation

Under the principle of “small government, big society,” the state is ideally “staying out areas where there is no need for government regulation, decreasing from where it can regulate less, and regulating aggressively where it needs be”. Government regulation is sometime necessary but it is also costly. Self-regulation by non-government mechanisms such as trade groups and voluntary associations can be more cost-effective.

In China, even though the state has been attempting to withdraw itself from certain areas of regulation, the exit mechanisms for the state to withdraw from the marketplace do not exist or are weak. Market institutions including what can be called “social groups” that can supplement or replace the state in the market as self-regulatory institutions. Ironically, having been left very weak in a tightly controlled society, professional groups and trade associations, whose counterparts in the market economies play an important self-regulatory role, often need the state to be lenient and nurturing toward their roles.

Related is the issue of regulatory strategies: One of information, the other of prescription (paternalistic). Should the state protect its citizens simply by providing them with information about suspected dangers and let them choose to accept or avoid the risk? Or should the state adopt the more interventionist strategy of making the choice for the consumer by prescribing the terms and conditions governing how a product may be consumed or an activity performed?

### Central-local Relations

As a defining theme in Chinese history, nothing is more significant politically and economically than the relations between the central government and local governments. Such relations have been described as a strategic game, particularly complicated during the reform period. Each major reform measures touched upon these relations and have been crucial to the success of the reforms. The rise of the regulatory state is no exception.

In fact, it is part and parcel of the evolving central-local relations. Arguably, the central government's frustration over losing fiscal and regulatory ability to local governments as a result of the decentralization was one source of regulatory reforms launched in the mid-1990s. Indeed it can be argued that the regulatory reforms were corrective responses to the problems caused by the decentralization which had had its successes in the early period of the reform.

The rise of the regulatory state has to a great extent re-structured the relationship between the central and local governments. Much of the regulatory regime is dominated by the central authorities and the regulatory structure tend to be verticalized. ...It has shown potentials to be successful in overcoming the perennial problem in the Chinese political-economic system: the oft-debilitating *tiao* and *kuai* conflicts.

The rationale for a more vertical structure of a regulatory regime is not novel. A successful market economy tends to be open and un-fragmented. Internal barriers and market fragmentation have plagued economic development in China and elsewhere. Scholars have argued that the rise of the regulatory state in the United States was also due a large extent to the need to assist the emergence of an un-fragmented national market in a federal system (see Mike Dowdle). The consequent regulatory regime that has become a model for many countries later was one that gave much power to the federal government.

In sum, in matured capitalist economies where the transition to regulatory state also took place, the states have long established essential institutions, and instruments of income redistribution and macroeconomic management. China and other transition economies, on the other hand, had to develop anew these institutions and instruments: in the new game of the market, the role of referee, for which the state had been trained, has to be learned. The state socialist past of these countries determine that all these institutions and instruments are seriously lacking. So it is not simple reducing the positive state—its mode of governance and institutions—and replacing it with regulatory institutions. For a transforming command economy, the changing role of the state from a planner and producer (“owner” and “player”) to a regulator and market-promoter (“referee” and “coach”) is particularly significant and indeed difficult. Despite many similarities shared with mature market economies in regulatory reforms, transition economies face somewhat different set of challenges. First, the existence of a weak private sector when the transition began means that the demands from private sector for regulatory reforms have not been strong. Thus, the “agency capture” is less a problem. Second, the large bureaucracies that were familiar with the rule of the game under a command economic system must be reformed to be able to acquire the new roles. Both the size and ethos of such bureaucracies are markedly different from those of mature market economies. Third, more significantly, as emerging market economies, the markets are nascent and weak. Market-related institutions, both formal and informal, are generally weak in these countries. Indeed, in many cases, they need to be built from ground up. It is a new game.

## IV. A New Game

What is a regulatory agency in the Chinese context? How similar is it to its counterparts in more matured market economies? Strictly speaking, regulatory agencies are those created by statutes (hence “statutory regulation”) operating outside the line of hierarchical control or oversight by the central administration (Majorne 1996: 48). They are semi-independent or independent government agencies with rule-making, adjudication, and enforcement power, usually delegated by legislation. In its broader sense, regulatory agencies include central ministries with regulatory power. Unlike the U.S. where federal departments do not directly function as regulatory agencies, some Chinese ministries have regulatory mandates.

There has been an emergence of a large number of market-related regulatory agencies, including both new agencies and new regulatory functions by existing bureaucratic agencies.

- a. Social regulation (See Table 1 and Table 2).

**Table 1. Social Regulation in China (1)**

<b>Regulatory Subject</b>	<b>Regulatory Methods</b>	<b>Regulatory Agency</b>
<i>Consumer Protection</i>		
Basic rights	Civil liability	State Administration for Industry and Commerce (SAIC)
Advertisement	Content approval, business license	SAIC, State Food and Drug Administration (SFDA)
Sales Methods	Entry approval, business scope, price check	SAIC, price authority
Real Estate	Appraisal, ownership registration	Urban planning/maintenance administration, SAIC, State Land and Natural Resources Administration (SLNRA)
<b>Health and Food</b>		
Medicine	Business license, quality control, product permit	SFDA National Bureau of Quality & Technology Control (BQTC), Ministry of Agriculture, SAIC
Health Care	Advertisement Permit, license	SFDA and SAIC Ministry of Health
Food	Health standards, sanitation permit, business license	SFDA, Ministry of Health, Ministry of Agriculture, BQTC, SAIC
Cosmetics	Business permit, product permit or license	SFDA, BQTC

Health Food	Approval, permit	SFDA, BQTC
<b>Public Safety</b>		
Product Quality	Product standards	BQTC, SAIC
Work Safety	Safety standards	Ministry of Labor, Ministry of Health,
<i>Environmental Protection</i>		
General Regulation	Standards, pollution levy	National Environmental Protection Agency (NEPA)
Air Quality	Standards, pollution levy	Local EPAs, Public Security, Transportation authorities
Water Quality	Standards, pollution levy	Local EPAs, water administration, public health, urban planning/maintenance
Solid Waste	Disposal approval, business permit, license	Local EPAs, urban planning/maintenance, public utility authority

**Table 2. Social Regulation in China (2)**

<b>Regulatory Subject</b>	<b>Regulatory Methods</b>	<b>Regulatory Agency</b>
<b>Unfair Competition</b>		
Antimonopoly	Investigation	SAIC
Business Fraud	Investigation, inspection	SAIC
<b>Natural Resources</b>		
Water	Water use permit, use charge	Water administration
Forest	Logging permit, ownership certificate	National Bureau of Forestry
Wildlife	Protection list, gaming permit, im/export permit, protection administration charge	National Bureau of Forestry, Ministry of Agriculture
Land	Land use permit, reclamation standards	Ministry of State Land & Resources, local Bureau of State Land & Resources Administration
Mining	Survey permit, mining permit, resources compensation charge	Ministry of State Land & Resources, Ministry of Water Conservation, National Bureau of Coal Industry

b. Economic regulation (See Table 3)

**Table 3. Economic Regulation in China**

<b>Regulatory Subject</b>	<b>Regulatory Methods</b>	<b>Regulatory Agency</b>
<i>Public Utilities</i>		
Electricity	Business permit, license, price by approval	State Power Regulatory Commission (SPRC)
Water supply	Registration, price by local government	Ministry of Construction (MOC), local urban planning/maintenance authority
Gas/heat	Local government monopoly, price by local government	MOC, local urban planning/maintenance authority
Public transit	Local government monopoly, price by local government	MOC, local city planning authority
Taxi	Business license, rates by local government	MOC, Ministry of Public Security, State Tourism Bureau, Price authority
<i>Postal Service</i>		
	State monopoly, regulated rates	Ministry of Information Industry
<i>Telecommunication</i>		
Long distance	Limited entry, permits, regulated rates	Ministry of Information Industry (MII)
Regional	Limited entry, permits, regulated rates	MII
Paging service	Permit, rates by local government	MII
Wireless and internet services	Limited entry, permits, regulated rates	MII
<i>Radio</i>		
	Approval, no price control	State Bureau of Radio, Film, and Television
<i>Cable Television</i>		
	Permit, rates by local government	State Bureau of Radio, Film, and Television
<i>Satellite TV and Radio</i>		
	Permit, rates by local government	State Bureau of Radio, Film, and Television, Ministry of Public Security, Ministry of State Security, SAIC, MII
<i>Transportation</i>		
National railroads	State monopoly, regulated rates	Ministry of Railway
Local railroads	Approval, rates by local government	Local railway authority
Special railroads	Approval, no price control	Local railway authority

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Air Transportation	Permit, license, regulated rates	Civil Aviation Administration of China (CAAC)
Water Transportation	Permit, license, price guidance	Ministry of Transportation
Road Transportation	Business license, no price control	Ministry of Transportation
Pipelines	Special permit	State Economic and Trade Commission?
<i>Finance</i>		
Commercial banks	Permit, business license	China Banking Regulatory Commission (CBRC)
Trust & investment Companies	Permit, business license	CBRC
Credit unions	Permit, business license	CBRC
Rural credit unions	Permit, business license	CBRC
Securities	Approval	China Securities Regulatory Commission (CSRC)
Futures	Approval	CSRC
Bonds	Approval	Ministry of Finance, CBRC, State Development and Reform Commission
Insurance	Permit, business license	China Insurance Regulatory Commission (CIRC)
<i>Construction</i>	Approval, business license	Ministry of Construction

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There are some bright spots or “pockets of efficiency” in the process of regulatory transformation. Some regulatory agencies, particularly those that were created anew (for example, CSRC), perform well enough to gain confidence among economic actors and consumers. Some pre-existing agencies have also shown signs of transformation. Take price administration for example. Chinese price authorities used to be proactive in setting prices until the late 1980s. But as the role of state in determining prices diminished, Chinese price administration gradually become mainly reactive and post facto in their regulatory methods. That is, only when a price-related case is brought to the attention to the agency, it will decide whether to act or not. It indirectly regulates prices. The main tools for regulation and monitoring is to use a “price regulation fund” to intervene. It also collects price information and makes predictions of price change. In this sense, it is not too different from FCC of the United States (Interview, Tianjin Price Bureau, 8/11/1998).

Still, in such a nascent market economy, regulatory institutions are far from efficient. Much of the problem lies in the imperative for the state to proactively maintain

order in the marketplace. Many regulatory agencies not only did not downsize, they actually expanded in recent years. Many now maintain a uniformed force of agents often called “inspectorate” (*jianjia dadui*), who routinely make inspections and investigations. Enforcement cost is high.

The large size of regulatory bureaucracy is compounded by a lack of clear regulatory mandate: Who has the power to regulate what? Which level of government has the power to mandate regulatory power? The “power struggle” among government regulatory agencies has resulted in overlapping jurisdiction and multiple “masters.” It creates confusion where regulatory process lacks transparency with multiple agencies involved. In Beijing, in the late 1990s there were over one hundred agencies with regulatory power and more than 60,000 agents roaming around the city. Still every agency complains about its own shortage of agents and lack of effectiveness in enforcement (*Guangming Ribao*, 8/4/98). At the same time, delegating more power to regulatory agencies creates a typical principal-agent problem: Most of these agencies have local branches, which serve both local government and the central agency. Besides the common problems of hidden action and hidden information from the principal, this also creates another problem--an agent attempting to serve multiple principals often finds that any action he or she might take to benefit one principal injures another (Kiewiet and McCubbin 1991). This exacerbated the long-existing conflicts between vertical and horizontal hierarchies (the *tiao* and *kuai*) in China.

### *Deregulation*

Until recently, governments at various levels in China have had enormous power to impose and enforce market regulations. Government permits, for example, are numerous. The central ministries once had in the late 1990s authority to issue some 2,500 kinds of permits and approval in total. A provincial government could have power to issue as many as 1,500 kinds of permit and approval. In some cases, to open a business requires several dozens of permits and approvals from, and countless visits to, government departments. Not only does it cost investors time and money, often government agencies reject business registration. In one case, a State Administration of Industry and Commerce, the regulatory body in charge of business registration, refused to register a firm on the ground that the business was deemed to be not profitable. Even some reform-minded officials such as the governor of Hubei Province openly criticize the complex and irregular regulations that have become bottleneck for improving investment environment.

Always being a harbinger of reform, Shenzhen was the first city to launch the reform in 1998 to reduce the number of government permits. But it was not until early this year when the reform was endorsed by the central government to be implemented nationwide. The Premier, Zhu Yongji, personally issued an instruction to launch the regulatory reform specifically targeting the large number of government permits and approvals. The reform was intended to reduce the number of permits by at least one third by either doing away with permits or transforming them into registration and/or filing. By the early 2002, most central agencies and provincial governments have reportedly

reduced 30%-60% of number of government permits and approvals (*Liaowang*, n.10, March 4, 2002).

What has prompted the government to launch the reform? Three main reasons were behind the decision to reform the existing system. First, government regulation in the form of ex ante permits and approval has become increasingly detrimental in the market economy and obstructive to a vibrant private sector in particular. Beijing wants this to be a new breakthrough that may lead to a more mature and open market economy. Second, China's entry into the WTO puts pressure on the Chinese government to reduce its regulatory barriers for foreign investment. Market opening commitment by the Chinese government requires national treatment of all investors. Liberal reformers also seize the opportunity of WTO entry to push for broader administrative reforms. Finally, as one of the new strategies to contain rampant corruption, Beijing realizes the need to reduce one of the major sources of corruption—administrative control over economic activities. This intention was made clear in a speech by China's anti-corruption czar Wei Jianxing in April 2001.

Unlike other reform measures that usually tricked down, regulatory reform was implemented at both provincial and municipal levels simultaneously from the beginning. So far, some half of all the provinces have reported reduction of number of permits and approval requirements. There have merged different models of reform. First, some provinces or cities such as Shanxi, Fujian, and Liaoning set up a "single processing station" system, namely, rather than going through numerous agencies to obtain approvals and permits, investors need only go through one office that has all concerned agencies represented with limited number of permits. Others such as Hubei, Beijing, and Shandong have decided to cut down the number of government permits by as many as 40 percent. Still others focus on devolution of power of permit and approval to lower level government agencies.

It is still too early to say whether this deregulation effort will produce concrete results. Many local governments have yet to take steps to reduce regulatory burden on investors. The economic and political significance of this ongoing reform, however, should not be underestimated. If successful, it would make China a country with fewer government regulations in the economy than Japan, which has also been undergoing regulatory reforms targeting numerous government permits. It would further stimulate a growing domestic private sector that today boasts of 1.5 millions firms employing over 20 million people. It is, with leadership's intention or not, part and partial of a more profound transition of the once interventionist state. It is worth noting that a senior official of Yunnan Province recently stated that the government should "seriously consider exiting from the economy," indicating a significant shift in how the regime views its role in socio-economic life. "Small Government, Big Society" will no longer be a shallow slogan if these reform measures are successful.

#### *Good Referee? Fair Game?*

Although the reforms have changed the way government bureaucracy operates, irregular and non-routine methods from the mobilization regime such as "core tasks", campaign,

target-setting, model-setting, goal-oriented responsibility personnel system are still used. Policies rather than laws and regulations were used to regulate the behavior of state agents and other economic actors. Policies, in the form of decrees, instructions, and drafts, are more flexible and temporary in nature. They can be followed only in “spirit”. The consequence is that a. lower units devised their own implementation rules and sometimes even counter-policies; b. Policies tended to be less effective and ad hoc, they were expected to be replaced by other policies. Numerous policy decrees on the same issue tend to have diminishing effect. Thus when prohibitive decrees were issued, say, against “small coffers”, they were often ignored. For instance, policy decree was used often in curbing unfair competition by SAIC In Shanghai, the municipal BIC issued “Opinion on Implementation of Severely Crack Down on Product Fraud” in 1988, and “Announcement of a Campaign to Search and Punish Unlicensed Products” (*Shanghai Gongshang Xingzheng Guali Zhi*, p.229).

Campaign method is often used by regulatory agencies as a regulatory instrument, as in the recent case of fake baby formula in which hundreds of babies suffered from malnutrition and poisoning including dozens of deaths. When a campaign is launched, e.g. annual price inspections (*wujia dajiancha*) or “safe food drive”, a certain problem or issues would become the focus. Usually, the punishments on deviant behavior are more severe than in the normal circumstances. Thus, the phrase “*dingfeng weiji*” is still used to denote the actions that violate rules while ignoring the ongoing campaign targeted precisely at such actions. For example, SAIC and BQTC routinely launch “anti-fraud,” “product quality inspection,” and “standard measurement inspection” campaigns in the marketplace. These campaigns are often carried during peak season of consumer product retail such as the New Year holidays (See *ZJNJ*, 1997:430-32). In the late 1980s, local SAICs were involved in a campaign to crack down on product frauds as a result of an “Announcement of Severely Crack Down on Product Frauds” from the State Council. Official journals routinely report on task-oriented campaigns as a way of showing resolve and results. For example, the journal *Supervision Work In China (Zhongguo Jiancha)* reported that a three-month campaign in early 1998 to crack down on unsanctioned road charges in Yiyang city, Hunan Province, achieved success with concerted efforts through media campaign, meetings, billboard slogans, and signing of responsibility contracts by local agencies. Many of these measures recall the methods of mobilization regime (*Zhongguo Jiancha*, n.4, 1998). Transport inspection bureau of Chanzhi city, Shanxi province, boasted the success of its “one-hundred-day inspection campaign” in 1995, which resulted in the collection of extra levies (*Zhengfu Fazhi*, n.7, 1996).

One of the more serious unintended consequences of the rise of the regulatory state is the widespread of rent-seeking by government agencies using regulatory power through charging fees, fines, and other impositions. As a result, transaction cost for economic activities increases and it creates heavy regulatory burden on businesses. Local governments compete to attract investment by lowering entry barriers and by offering favorite terms of tax rebate or exemption, expedient approval process, better infrastructure, etc. Yet, once the investments begin generating profits, government agencies also compete to squeeze a share by charging various fees, levies, and imposing involuntary donations to local projects. Some describe the situation as “opening door to

attract investment, but beating up the dogs with closed door” (*Zhongguo Gaigebao*, 6/10/98). In 1996, local government agencies once had more than 3,400 charge items. The total amount was estimated at 400 billion yuan in 1996, or an equivalent of 47 per cent of the national fiscal revenues that year (*Liaowang*, n29, 1998: 9). In one of extremes cases, Gansu Province collected 4.5 billion yuan worth of non-tax revenues of levies, which accounted for 65.9 per cent of the annual fiscal revenue in that province in 1996 (*Ibid.*). According to one estimate—there are no exact statistics on the amount of informal charges for the obvious reason of avoiding sanctions—currently there are some 1,000 fees and other charge items. The ratio of formal taxes and informal levies paid by business companies is about 1:1. For individual vendors and self-employed businessmen, the ratio is 1:1.7 (*Zhongguo Gaigebao*, 7/8/98).

“*Quis custodiet ipso custodes?*” (Who guards the guards themselves?) Who, then, can prevent the referee from abusing his power and disrupting a fair game? That is, how can regulatory agencies be restrained from confiscating property rights and from preying on economic agents? Political control through a representative body does not exist in China. Independent court system is one of the answers, as Ericson found in the post-communist Russia (Ericson, 1997). Theory of principal and agent assumes that information is asymmetrically distributed. Agents usually have more information than their principals do about the details of the task assigned to them, and about their own preferences, abilities and actions. Hence they take advantage of the high cost of measuring their characteristics and performance to engage in opportunistic behavior. Under democratic regimes, agency cost is reduced by legislative measures that frame certain incentive structures through statutes and devised mechanisms to monitor the behaviors of the agents (Weingast and Moran, 1983; Wood and Waterman, 1991).

Formal institutions, which function to constrain government agents of abusing power, are weak. In China, horizontal accountability of government agencies is very limited. Representative bodies such as the People’s Congress is ineffective at best, even though in theory it has the oversight rights over bureaucratic agencies (Tanner 1998). Although there are “agencies of restraint” (Collier, 1996), China does not have an independent court system which can effectively curtail the misconduct of government officials. In theory, disciplinary agencies such as the Party Disciplinary Commission, People’s Procurate, Auditor’s Office, and Supervision Bureau as well as the legislature of a given level are mandated to monitor and discipline the behavior of government agents. In practice, the regime has to rely on vertical accountability to monitor the behavior of lower-level units. For instance, township agencies are mostly responsible to county government agencies rather than to township government. County governments intentionally try to reduce the power of township governments precisely because they fear of the weak control and oversight over township agencies by township governments. Thus, the distrust of lower level governments and lack of horizontal accountability led to more vertical control, which incurs more opportunity costs.

Progress has been made in recent years to provide a legal framework which citizens may sue government agencies and agents for wrongdoing and violation of administrative procedures. Government agencies now face potential threat of lawsuits.

Indeed, they may lose in administrative litigation cases. Some local governments began to retain attorneys in administrative agencies. Shanghai's Pudong New District, which led the country in many administrative reforms, is the first in the nation to implement this system. A "Experimental Regulations on Government Attorneys" was approved by the Shanghai municipal government in August 1995. In 1996, the Pudong government hired the first group of government attorneys for eight agencies and a government-run tax-free zone (Wang and Chen, 1998).

The Administrative Penalty Law which was passed by the NPC in 1996 was aimed at regulating the conduct of regulatory agencies by stipulating who and how to impose administrative penalties.

New regulations went into effect on January 1, 1998 which stipulates a separate of the assessment, collection, and retention of penalties by government agencies. Prior to the new regulations, the same government agencies both assessed and collected fines, which gave incentive to over-exaction and often eluded audit. Now all fines are to be collected by state-run banks or other officially sanctioned special collection agencies. All administrative fine revenues must be turned to the state treasury and subject to regular audit (See *RMRB*, 11/27/97).

There are, however, informal means for people to address their grievance and constrain possible misconduct of local authorities. They often develop and utilize personal connections in government departments at higher levels. Ordinary citizens especially peasants have learnt to make their appeal to higher authorities through letters or visits.

Chinese judicial system is not totally independent of political influence. But it does not prevent the courts from making independent investigation and judgement. Since the promulgation of several administrative laws, the administrative litigation cases where citizens or businesses sue government agencies have been on the rise. Government agencies, both regulatory and superordinate, such as public security bureau (see *Zhengfu Fazhi* n.6, 1993), construction bureau (*Zhengfu Fazhi*, n.1, 1994), tax bureau (*Ibid*, *Zhanfu Fazhi*, n.1, 1995), SAIC (*Zhengfu Fazhi*, n.3, n.5, 1996), TVE administration (*Zhengfu Fazhi*, n.4, 1996), township government (*Zhengfu Fazhi*, n.1, 1995), and bureau of commerce (*Ibid*). Government agencies, especially regulatory agencies, are required by law to maintain a regular "compensation reserve fund" in case of losing administrative litigation. Many, as the Bureau of Planning and Development of Pudong (Shanghai), also retain lawyers to deal with possible administrative litigation (Interview). These are potential, if not yet potent, guards against possible regulatory abuse by government agencies.

As the markets emerge in China, they have often rendered tumultuous. The need to maintain market order with established rules of the game becomes increasingly salient. Such a need gave rise to regulatory institutions including both laws, regulations and enforcement agencies, which are instrumental in China's success in its transition to a market economy. Incomplete market requires different sets of institutions from those in

more matured capitalist economies to make it work. Regulatory institutions—laws, enforcement agencies and agents—give signals of government commitment to the market.

As with European countries where regulation through public ownership was gradually replaced by American style statutory regulation by regulatory agencies, China's transition to a regulatory regime also shows the need for a clear separation of regulatory and operational responsibilities (Majone, 1996: 53). The pre-existing institutions have seriously impeded the emergence of an effective regulatory regime. Institutional legacy is significant in shaping the post-central-planning state. It created a central dilemma for all transitional regimes—the state is required to be strong and effective enough to wither and withdraw itself from over-intervention for which it is well known. It is not impossible to solve the dilemma, though, as the Chinese experience shows. Such path-dependence is evidenced in the fact that most regulatory agencies in China are transformed from pre-existing (central-plan orientated) functions to regulatory functions. The dual-role many ministries had—both supervised production and regulate the sector. The Ministry of Health is an example of such a dual-role. Another important sector where the government ministry both operates and regulates is telecommunications (MII), although this is rapidly changing as China joins the WTO.

Institutional change is a long and arduous process. The transition from a redistributive to regulatory state involves fundamental change in political, legal, and economic institutions. It is already happening. Despite all the problems, such a transition has already brought many changes that have already shown their vitality. One can argue that if the first decade and half of the reform in China was marked by the strong developmental role of the state through decentralization, the second decade and beyond has seen and will continue to see the emergence of a regulatory state through the redefinition of relations between the state, the economy, and society. The impact of such developments is profound.

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