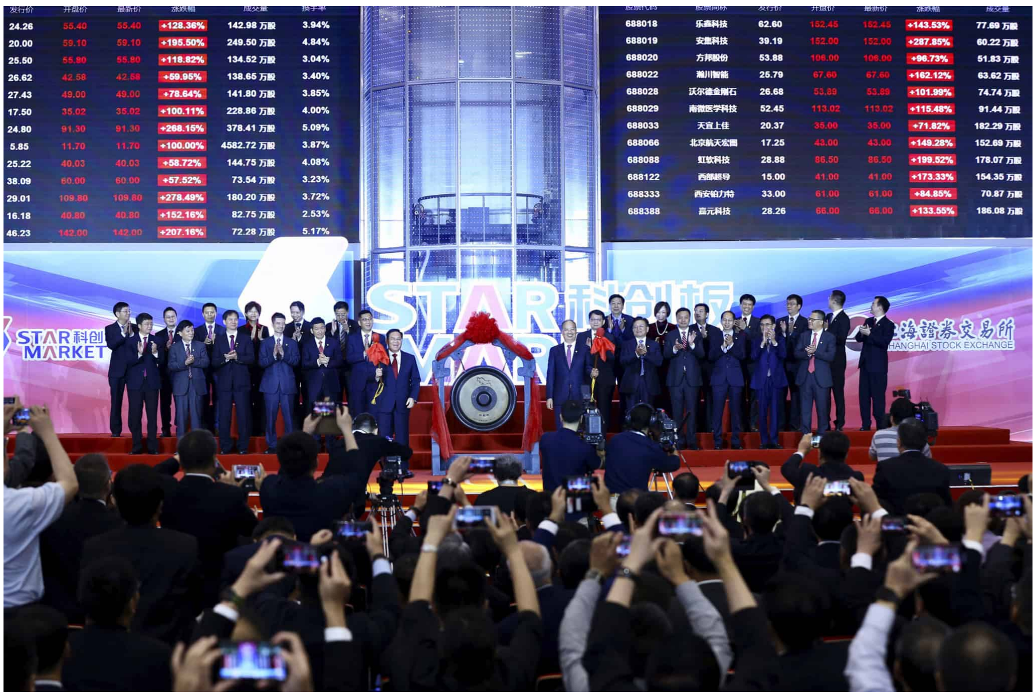
The Wire China

OPINION

Two Strong Hands

China's vision for the private sector.

BY CHANG-TAI HSIEH — MAY 22, 2022



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Over the last two years, China has cracked down on some of its most successful companies, including Alibaba, Tencent, Didi, and Meituan-Dianping. Starting in 2018, the authorities have also restructured many of China's largest conglomerates such as the Wanda and Evergrande groups. The conclusion many have drawn is that China's decades long embrace of markets and private enterprise is coming to an end.

Yet over the same period, China has also quietly enacted a large number of business-friendly reforms, aimed at reducing red tape for small- and medium-sized firms, making it easier for them to raise capital, and smoothing their access to the country's legal dispute resolution processes.

This apparent contradiction in China's policy direction — an ongoing crackdown on the largest Chinese firms combined with strong support for smaller private firms — in fact reflects the Communist Party's dual objectives: retaining total control while still allowing the private sector to thrive. The Party has targeted large private firms, not because of a desire to return to Mao's socialist economic vision, but due to fear that their growing power threatens Party control. At the same time, there is a widespread recognition that without a vibrant private sector, the economy will wither and the Party cannot survive.

The result is what I call a strategy of using "two strong hands": The first involves eliminating all threats to the Party's control, while the second lends support to private firms that serve its interests by delivering growth, jobs and innovation — without becoming too powerful.

THE CAMPAIGN TO RESTORE PARTY CONTROL

In the early 2010s, there was a widespread view within the Party leadership that large private firms threatened its control. This was partly the same fear of governments throughout the world that the wealthy are becoming too powerful. In China, the potential threat is even greater because almost every successful private firm has close ties with local governments, which can use their enormous administrative capacity to support their interests.

Local cadres have long championed private firms because it is the most effective way to grow the local economy and employment. This economic objective has also been a top-level priority for the Party, which promoted cadres who showed competence in helping private business to develop. Over time, however, it became increasingly common for local cadres to derive financial benefits from the success of these businesses. Many party officials and their families owned (often hidden) equity stakes in private companies, for example.

For the Party, this trend meant an erosion of its control. Cadres often came to care more about the success of their favored private companies than loyalty to the Party. In turn, their political decisions were increasingly driven by private interests.

The influence of private businesses became so widespread that it was viewed as an existential threat to the Party. Its response has been to strengthen its control with the "first strong hand." The anti-corruption campaign since 2012 should be viewed in this context: Most of the cases have involved private businesses bribing Party officials. The campaign's central agenda has been to restore Party oversight over its cadres, and to cut them off from undue private sector influence.

This "first strong hand" has tightened Party control in other ways. Party cells have been installed in private firms and non-government organizations, while the authority of CCP committees in state-owned firms as well as universities and hospitals has widened. The Party has also acquired "golden shares" (shares with veto power) in companies with internet platforms, media companies, and data-intensive companies.

The Party is especially sensitive to any sign that the private sector is undermining its authority over personnel appointments and ideology. Loyalty to the Party now drives cadre promotion decisions, often over ability. Local-level cadres who might previously have spent most of their time supporting business development now spend it in political study sessions, or hosting Party inspection teams.

China's crackdown on private firms is thus part of the ongoing campaign to restore Party control. Companies and individuals that threaten that control have been brought to heel, from wealthy individuals and celebrities to after-school tutoring companies and internet or media firms.

THE CAMPAIGN TO SUPPORT A DESIRABLE PRIVATE SECTOR

Despite the Party's fear of the power of major corporations, there is no desire to return to Mao's socialist model. The leadership remains convinced that China's embrace of the private sector since the early 1980s has delivered unprecedented growth and improved living standards — and, more importantly, has reinforced its own legitimacy.

Of course, one inevitable consequence of cracking down on China's most successful companies is that it hurts growth. The response has been a broad campaign to support the private firms that deliver jobs, growth and innovation, but aren't yet powerful enough to threaten the Party's control.

This campaign — which I dub the "second strong hand" — has multiple components aimed at relaxing the regulatory, legal and financial constraints detrimental to the development of private businesses, especially SMEs and technology startups. Every locality in China now has a one-stop or online registration system to set up new businesses, for example, while the amount of capital needed to register a new business has been reduced.

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China's judicial system has become more streamlined and business-friendly too. Many specialist courts have been set up, including more than a dozen intellectual property-focused courts. A new bankruptcy law has created courts that only deal with such cases. China claims to have published more judicial ruling texts online than any other country: Enforcement of court decisions has also improved since 2016 too, partly thanks to the legal system's greater access to the integrated online personal information.

Small, private firms' access to finance and capital markets is getting better. Chinese banks overall increased the credit given to small firms by 27.3 percent in 2021, with large banks — acting on government orders — raising it by over 40 percent. The Shanghai Stock Exchange's new Science and Technology Innovation Board (STAR Market) opened in 2019 with a simplified IPO procedure, while a third stock exchange opened in Beijing in 2021, aimed primarily at listing SMEs. Both markets provide convenient exit channels for the ballooning number of private equity-backed start-ups in sectors from semiconductors to electric vehicles.

Since 2018, the State Council has also made "cutting taxes and fees," mainly for businesses, a policy priority, resulting in cuts worth over 2 percent of GDP in both 2019 and 2020.

The upshot is an explosion of small and mid-sized firms over the last decade, with the number of business entities increasing from 55 million in 2012 to 150 million in 2021. This sharp rise in active businesses has likely created tens of millions of new jobs, a core priority for the Communist Party, whose legitimacy has long rested on its ability to provide China's vast population with employment.

WILL THIS MODEL WORK?

The effect of these two 'strong hands' will reverberate for the foreseeable future. The Party will continue to crackdown on large Chinese private firms that threaten its control, and keep pursuing its campaign to support startups and SMEs that serve its interests.

The default view of Chinese economic reformers is that the 'two strong hands' strategy will not work long-term, because total Party control will eventually undermine the market economy. Smaller companies might stop investing to grow, for fear of becoming 'too big' and hence finding themselves in the Party's firing line. In this view, the 'two strong hands' are thus fundamentally incompatible.

The default view of Western political scientists is similar, albeit coming from a different angle. They would argue that the 'two strong hands' will come into conflict with each other, as millions of entrepreneurs and a rising middle class will eventually threaten the Party's control of the political sphere.

Whether or not the 'two strong hands' can co-exist successfully is ultimately an empirical question. If the Chinese economy can maintain its private-sector driven growth momentum while the Party consolidates its power, the strategy will be judged a success. The key unknown is whether the Party's efforts to support its favored parts of the private sector can spur enough growth to outweigh the negative effects of its crackdown on other, less favored areas. How much is lost if entrepreneurs know that it could be dangerous to be the next Alibaba, and how much is gained by the creation of millions of new small firms? Can a private sector of many "million-dollar companies" drive an economy with fewer "billion-dollar companies"?

One can always find evidence in today's China to support opposing views. While the overall urban unemployment rate remained relatively low, at 5.1 percent in 2021, the rate for the 16-24 age group was much higher at 14.3 percent. Layoffs at big tech companies like Tencent and Alibaba have been harmful, but some of those laid off are finding work at smaller start-ups. Despite aggregate figures showing better access to credit for SMEs, some private businesses still complain about its availability. Investors in China's stock markets have swung from dismay at government crackdowns to euphoria at its supportive private sector measures.

What's clear is that this model has never been seen before: a market economy with a large private sector under the control of the Communist Party. China has returned to a Maoist model of political control, but not the Maoist economic model of central planning and reliance on state-owned firms. The private sector remains central to the success or failure of the 'two strong hands' strategy. Allowed to thrive, it will underpin Party's continuing control. But if this model does not work, then either the Chinese economy or the Chinese Communist Party — or both — will surely stumble.

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