Experimentation under Hierarchy: Policy Experiments in the Reorganization of China’s State Sector, 1978-2008

Sebastian Heilmann

CID Working Paper No. 172
June 2008

© Copyright 2008 Sebastian Heilmann
and the President and Fellows of Harvard College

Working Papers
Center for International Development
at Harvard University
Abstract: The reorganization of China’s state-controlled enterprises after 1978 was subject to strong political inertia and opposition. Powerful vested interests and ideological concerns stood in the way of transformative change. Against this background, one central puzzle in China’s restructuring efforts lies in how policymakers managed to overcome these constraints and to promote new policies and institutions that changed the rules of the game.

The Chinese experience demonstrates how a succession of policy experiments can drive the generation of restructuring measures and transform basic policy parameters. From 1978 to the mid-1990s, recurrent rounds of experimentation under hierarchy (a process of policy generation that legitimizes local initiative while maintaining ultimate hierarchical control) resulted in protracted policy tinkering with bureaucratic and financial incentives or formal corporate reorganization, yet without touching the politically protected and financially privileged status of the state-owned enterprises in the economy. Incremental reforms minimized political conflict and social disruption but did not eliminate the misallocation of resources and therefore may be judged as wasteful in narrow economic efficiency terms.

Yet, seen from the perspective of policy learning, the contribution of experimental tinkering to transforming the policymaking context of local and central decision-makers was essential. It provided test-runs for novel administrative and business practices, initiated behavioral and attitudinal changes among state managers and bureaucrats, and thereby undermined entrenched ideologies and interests. Experimentation resulted in serial, and cumulatively radical, redefinitions of the policy parameters for economic activity and prepared the ground for broad reform departures that were finally triggered by transnational push factors such as the Asian Financial Crisis and the WTO accession negotiations.

Keywords: experimentation, China, state enterprises, restructuring, economic policy-making

JEL Codes: D72, D73, N45, P31
Abstract

The reorganization of China’s state-controlled enterprises after 1978 was subject to strong political inertia and opposition. Powerful vested interests and ideological concerns stood in the way of transformative change. Against this background, one central puzzle in China’s restructuring efforts lies in how policymakers managed to overcome these constraints and to promote new policies and institutions that changed the rules of the game.

The Chinese experience demonstrates how a succession of policy experiments can drive the generation of restructuring measures and transform basic policy parameters. From 1978 to the mid-1990s, recurrent rounds of experimentation under hierarchy (a process of policy generation that legitimizes local initiative while maintaining ultimate hierarchical control) resulted in protracted policy tinkering with bureaucratic and financial incentives or formal corporate reorganization, yet without touching the politically protected and financially privileged status of the state-owned enterprises in the economy. Incremental reforms minimized political conflict and social disruption but did not eliminate the misallocation of resources and therefore may be judged as wasteful in narrow economic efficiency terms.

Yet, seen from the perspective of policy learning, the contribution of experimental tinkering to transforming the policymaking context of local and central decision-makers was essential. It provided test-runs for novel administrative and business practices, initiated behavioral and attitudinal changes among state managers and bureaucrats, and thereby undermined entrenched ideologies and interests. Experimentation resulted in serial, and cumulatively radical, redefinitions of the policy parameters for economic activity and prepared the ground for broad reform departures that were finally triggered by transnational push factors such as the Asian Financial Crisis and the WTO accession negotiations.

Keywords: experimentation, China, state enterprises, restructuring, economic policy-making

JEL codes: D72, D73, N45, P31

The reorganization of large state-controlled enterprises has arguably been the toughest job for Chinese policymakers over the last three decades. State-sector restructuring has been subject to very strong political inertia and opposition that are inherent in a socialist and post-socialist political economy.

Traditional socialist ideology stresses the dominant role of public ownership, the central position of the industrial working class in the political economy, and the redistributive goals of economic planning and policymaking. All three ideological elements have continued to be highly contested issues in the politics of corporate restructuring in China. Each of them has become a line of defence for powerful interest groups.

The managers of state-owned enterprises (SOEs) lobbied their political-bureaucratic superiors to keep budget constraints soft and access to preferential loans open. Public-sector workers and
pensioners protested against the risks and burdens they faced due to the reorganization or closing down of their long-time workplaces. Therefore, since the 1980s, containing the social repercussions of the SOE restructuring and the dampening ideological controversies about the appropriate extent of state control in the economy have been pushed to the top of the agenda of Chinese policymakers.

Moreover, decision-making at the apex of China’s political system is hampered by informal consensus rules. Controversial policy proposals are rarely pushed through by a lone decision of the Communist Party’s general secretary or by a majority vote in the Politburo. Rather, they are postponed until a consensus among major policymakers can be reached. Such decision-making rules are not conducive to producing determined and consistent national policies in a highly controversial and ideologically charged policy domain such as state-sector restructuring. Institutional rivalries among entrenched national bureaucracies (more or less reformed socialist-era commissions and ministries) and the emergence of increasingly assertive new players in national policymaking (in particular the Standing Committee of the National People’s Congress as a legislative body; the Supreme People’s Court as a quasi-policymaker through judicial interpretations of insolvency proceedings; and since 2003 the State-Owned Assets Supervision and Administration Commission [SASAC] as a new regulatory body) made the formulation and revision of restructuring policies very complex affairs.

Against this background of reform inertia, one central puzzle in China’s restructuring efforts has been to explain in how policymakers managed to overcome the constraints and promote the new policies and institutions that changed the rules of the game. Differences in initial conditions and economic structure may explain why China had the potential to introduce market competition with less disruption than there occurred in the former socialist economies of Eastern Europe. But initial conditions do not determine how effectively policymakers make use of them. In order to explain China’s remarkable “adaptive efficiency” in promoting growth, investment, and trade, changing the behavior of state and market actors, and establishing new economic institutions, we must take a careful look at the policy processes that propelled the restructuring in spite of the severe reform inertia.

The Chinese experience with state-sector reform provides important insights into how distinctive policymaking patterns shape the choice of restructuring policies. In most domains of China’s economic reform since 1979, policy changes were produced by a process in which the central policymakers encouraged local experimentation to generate novel policy options that could then be fed back into national policymaking. Experimentation served as a crucial means for avoiding policy deadlock and reducing the frictions and delays that are characteristic of top-level consensus-building and inter-agency accommodation. It helped to reduce risks in policymaking, stimulate policy entrepreneurship, and contributed to a fine-tuning of policy content and implementation. In policy domains in which new actors, interests, and ideologies entered national policymaking, such as foreign trade and investment or privatization over the 1990s, experimentation went beyond incremental adaptations and resulted in transformative departures marked by the emergence of new policy regimes with new constellations of actors, interests, institutions, and ideologies.

However, in China’s state sector, powerful vested interests and socialist ideological concerns stood in the way of transformative change. From 1978 to the mid-1990s, recurrent rounds of experimentation resulted in protracted policy tinkering with bureaucratic and financial incentives or formal corporate reorganization, yet they did not touch the politically protected and financially privileged status of the SOEs in the economy. Incrementalist reforms minimized political conflict and

---

social disruption but perpetuated a misallocation of resources, subsidies, and loans and therefore were wasteful in narrow economic efficiency terms. Seen from the perspective of an evolutionary political economy and policy learning, however, the contribution of experimental tinkering to transforming the policymaking context of local and central decision-makers was essential. It provided test-runs for novel administrative and business practices, initiated learning processes and behavioral changes, and thereby undermined entrenched ideologies, attitudes, and interests. In short, policy experimentation helped to “smuggle changes into the system.” And, in combination with transnational push factors such as the Asian Financial Crisis and the WTO accession negotiations, experimentation provided the policy planks for the broad reform departures in 1997 and 2001.

In the first section of the following analysis, I briefly contrast the distinctive policy cycle that we find in China with the conventional process of policymaking. To examine the implications of the experimentation-based approach for state-sector restructuring, I identify the general constraints inherent in this policy domain and then turn to a case study of bankruptcy regulation which has been a particularly contested area for more than two decades. As a next step, I look at the political and economic drawbacks of state-sector experimentation. The concluding section deals with how experimentation, although subject to stiff political limitations, prepared the groundwork for the post-1997 policy breakthroughs.

### China’s Experimentation-Based Policy Process

The Chinese experience in developing and implementing economic reforms differs in fundamental aspects from standard assumptions about policymaking. The conventional policy process model holds that policy analysis, policy formulation, and embodiment in legislation precede implementation. One core principle of policymaking in rule-of-law systems is that administrative implementation must come after parliamentary legislation or executive regulation and must be based on formalized, publicized, and therefore verifiable and actionable general rules. The priority of the law and the principle of law-bound administration basically rule out discretionary and experimental administrative measures in advance of the enactment of laws and regulations. One striking feature of this legislation-centered policy process is that the potential impact of the policies under deliberation must be assessed ex ante, without being able to test new policies (or at least some key elements) in practice beforehand and thereby to obtain realistic information about the potential effects.

In China’s reform experience, many successful innovations have been the result of administrative “groping along,” that is experimentation during implementation. Frequently there was little, if any, policy impact assessment, administrative coordination, and consensus-building in advance of the testing of new policies. Policy analysis and codification came only after experience, and after it could be determined what would work in the administrative reality. This mode of policy-crafting is the main source of the unorthodox regulatory practices and unclarified property rights regime that have accompanied the strong economic growth in China. Thus, discretionary administrative

---

4 This is how Charles E. Lindblom characterizes the tactics of introducing indirect changes over time in American politics; see his article “Still Muddling, Not Yet Through,” *Public Administration Review*, Vol.39, No.6 (November-December 1979), pp.517-526, at p.521.


experimentation in advance of legislation plays a crucial role in China’s policy process. Universal rules are mostly made only after real-life test-runs and after obtaining experience about which ways of handling a problem have the potential to work in practice. In short: experience first, laws later.

The mode of central-local interaction that we find in China’s policy cycle does not easily fit into conventional social science models of policy implementation and central-local relations. In research on China’s reform, administrative decentralization is often cited as the key change that has triggered local state activity. However, Chinese governance of reform goes beyond sweeping administrative decentralization and spontaneous diffusion of successful experiments. It requires the authority of a central government. The Chinese pattern of experimentation under hierarchy is focused on finding innovative policy instruments, rather than defining policy objectives, which remains the prerogative of the top political leadership. With regard to the means of reform, the experimental process is decidedly open and regularly leads to decentralized initiatives that cannot be anticipated by the center. Political actors at various levels thereby become initiators and active participants in the reform drives. But ultimate control over confirming, revising, terminating and spreading local policy experiments rests with higher-level decisionmakers.

In the making of China’s economic reform policies, experimentation is much more prevalent and institutionalized than the available literature suggests. It has provided policymakers with a veritable laboratory for policy innovation. In this laboratory, the constant search for new policy solutions is not driven by the ex ante policy debates and impact assessments that are typical of democratic law-making. Instead, policy adaptation is built into administrative practice and made a permanent enterprise. It is based on the administrative discretion and entrepreneurship exercised by local officials. This clearly stands in contradiction to law-based administration as an indispensable foundation for the rule of law. In practice, China’s local administrators tested all sorts of measures over the course of the economic reforms even if they contradicted official laws and regulations. Thus, China’s mode of policy experimentation is incompatible with strict rule-of-law standards. But in developing new and practicable policy options, this approach to reform-making has offered a broader and more flexible range of instruments to policymakers than could have been provided by a legislation-centered policy process.

Experimentation, Inertia, and Complementarities

Almost all crucial economic reform initiatives in post-Mao China were prepared and tried out by means of “experimental points” (pilot projects) before they were universalized in national regulations. This applies to SOE restructuring in particular (see Table 1). I need not go into the policy history of restructuring since the crucial steps and advances in restructuring have already been elaborated elsewhere. What I want to stress here is the importance of local “experimental point work” and central

---

7 Thomas G. Rawski, “Implications of China’s Reform Experience,” The China Quarterly, No. 144 (December 1995), p.1155, states that “the mix of top-down initiative and bottom-up reaction is itself a variable element within the reform mechanism.”


adoption of “model experiments” for national economic regulation. China’s experience with policy-based bankruptcy regulation from 1984 to 2007 is a major example of this type of policy process.

Designed as a response to the chronic SOE deficits, experimental programs in the 1980s were mainly oriented to giving additional incentives and decision-making powers to SOE managers, albeit without transforming the bureaucratic institutional set-up outside of the companies. Reformist experimentation met with strong reservations from parts of the policymaking community, industrial bureaucracies, and the national legislature. In effect, SOE restructuring that aimed at full-scale corporate reorganization turned out to be unachievable.10

| Table 1: Application of the “experimental point” method in SOE restructuring since 1978 |
|---------------------------------|----------------|
| delegation of greater autonomy to enterprises | 1978-1980 |
| delivery of contract profits to the state | 1981-1982 |
| substitution of profit with taxes | 1983-1986 |
| transformation of SOEs into shareholding companies | 1984-1997 |
| bankruptcy regulation | 1984-2007 |
| preparation of national SOE law | 1984-1988 |
| SOE responsibility contracts | 1987-1993 |
| establishment of enterprise groups | 1991-1997 |
| “grasp the big [SOEs], release the small [SOEs]” (Chongqing experiments) | 1994-1995 |
| “modern company system” (corporatization of large SOEs) | 1994-1997 |
| deepening corporate governance reform in large SOEs | 2003-2005 |
| complete transfer of social functions of large enterprises to local governments | 2004-2005 |


In the mid-1990s, an ambitious new attempt to transform SOE operations was undertaken with the “modern company system” (MCS) experimental program. In the face of increasingly large debts in the state sector, a consensus for a thoroughgoing SOE restructuring took shape among the top policymakers. As a result, a new Company Law was passed in 1993 that envisaged the transformation of SOEs into modern business entities with transparent structures of corporate governance, while still shunning the privatization of state assets. Policy implementation was based on “post-law experimentation”: MCS experiments were designed to smooth the implementation of a reformist national law. However, the experimental points established between 1994 and 1997 revealed how tacit resistance from SOE managers and their supervisory agencies could produce a heavily bureaucratized design for experimentation and consequently meager results. An evaluation of MCS implementation in the 100 centrally supervised experimental companies at year-end 1996 concluded that “almost no experimental enterprise had achieved the minimum standards of a modern corporation.”11

Overall, experimental programs undertaken in the state sector appeared inhibited and clumsy in comparison to the pioneering experimentation that was possible in these policy domains driven by rapidly ascending new economic actors such as foreign investment or private business. China’s state sector represented a policy domain that remained under the control of vested interests. Established actors in the state sector aimed to lock in partial reforms and to allow only incremental change. By the mid-1990s, as a result of one and a half decades of incremental change, SOE management had moved away from the plan coordination of earlier times, but it was still dominated by the socialist legacy of soft budget constraints.

---

A special challenge in the reform of SOEs was the necessity for “comprehensive coordinated reform” due to the fact that socialist SOEs were not just firms but, with regard to their extensive social functions (including kindergartens, schools, hospitals, pension funding, administration, etc.), were comparable to a self-contained municipality. Therefore, corporate reorganization and bankruptcy posed many more difficulties than they did in Western political economies since they had to go far beyond the transfer of ownership rights, debt restructuring, or liquidation. The close interrelation between SOE debt and China’s state-controlled banking system that became manifest in the huge amount of non-performing loans was another, and from a systemic perspective even more pressing, challenge to policymakers. Radical SOE restructuring would likely lead to knock-on effects in the shape of massive social unrest and bankruptcy of state banks. In essence, many crucial elements in the political economy had to be reformed in a coordinated fashion so as to contain the social and financial repercussions of the SOE reform.

As early as the mid-1980s, selected municipalities were designated as experimental sites for coordinated reform. But local experimenters were not in a position to deal effectively with the overarching institutional deficiencies regarding the state functions in the economy or the social insurance system whose transformation was indispensable for meaningful SOE reform. Up to 1997, reforms of the state economic bureaucracy were implemented as a formalistic exercise based on renaming and re-arranging old structures and redistributing their staff, yet without transforming government operations. By the mid-1990s, state-sector restructuring appeared to be stuck.

The sluggish policy regime in China’s state sector was eventually broken up only when the mounting debts were perceived as a systemic threat against the backdrop of the Asian Financial Crisis, an improved fiscal capacity made it possible to compensate the losers of the restructuring, and a forceful policy entrepreneur, Premier Zhu Rongji, used this policy window to achieve a reform breakthrough. In 1997 China’s central policymakers mustered the determination and means to move beyond incremental reform and to deal with the intertwined policy reforms simultaneously. They adopted a plethora of transformative policies to turn the SOEs around, including large-scale mergers, management and employee buyouts, takeovers of small SOEs by private investors, complete closures, massive layoffs, entry of foreign strategic partners, and exposure to international competition through WTO accession.

Generally, China’s experience with institutional complementarities in the state sector appears to confirm the argument that it is not possible to achieve systemic restructuring by introducing one piecemeal reform after another in succession. Indeed, the policy breakthrough in SOE reform in the late 1990s displayed the potency of a broad approach to tackle corporate, administrative, and social reforms simultaneously, not separately. Generous and often indiscriminate central government compensation to those affected by the corporate reforms was the precondition for the success of the new policy paradigm of “grasping the big [SOEs], releasing the small [SOEs].”

However, corporate reform was not implemented as a holistic, universal, and law-based policy package but rather was achieved through a policy-based ad hoc approach to solving the problems of individual enterprises at opportune points in time. Most of the policies that were part of the post-1997 breakthrough in restructuring (including the radical approach of “grasping the big, releasing the small,” which had been tested beforehand in the large and diverse state sector of Chongqing Municipality in 1994-95) had already been tried out in experimental sites in the preceding years and therefore constituted novel approaches whose risks were seen as calculable. A series of experimental point programs had already tested the waters and prepared the ground for “proceeding from point to surface”

---

as soon as a policy window opened. As a result of prior experimentation, post-1997 restructuring though still costly, discretionary, and controversial, was based on the local knowledge, administrative experience, and policy learning that had been obtained from the earlier decentralized experimentation.

To sum up, from 1978 to the mid-1990s, reforms at the core of China’s socialist economy, i.e., the state-owned enterprise sector, took place in a policy subsystem that was dominated by powerful entrenched state bureaucratic and enterprise actors with strong vested interests and shored up by official ideological adherence to state control over strategic economic assets. Under such restrictive conditions, policy experimentation was confined to tinkering with a policy repertoire that continued to be based on bureaucratic instruments and incentives for rendering SOE management less wasteful.

**Defying Bankruptcy Orthodoxy: Insolvency by Policy, 1984-2007**

Insolvency regulation can be regarded as a major test case to show how serious and effective state-sector restructuring came about and was pursued at the end of the 1990s. Insolvency provisions are characterized by international organizations and their economic advisers as a central pillar of a modern corporate structure that safeguards the interests of creditors and investors, and as an indispensable instrument for restructuring either through corporate rehabilitation or liquidation, especially in the case of the insolvent SOEs in the post-socialist economies. After the Asian Financial Crisis (1997-99), insolvency and related laws were presented as “vital to economic development and stability” by international bodies that had to deal with the fallout from the crisis. Under the buoyant economic conditions that had prevailed prior to the crisis, governments had neglected to regulate and administer insolvency effectively. According to a strongly worded G-22 working group report, the Asian financial crisis highlighted:

the critical importance of strong insolvency and debtor-creditor regimes to crisis prevention, crisis mitigation and crisis resolution. Effective national insolvency regimes contribute to crisis prevention by providing the predictable legal framework needed to address the financial difficulties of troubled firms before the accumulated financial difficulties of the corporate sector spill over into an economy-wide payments crisis.

According to this approach, indispensable institutional features of an effective insolvency regime include consistent national legislation that protects the interests of creditors and investors, independent courts that handle insolvency proceedings in a competent and reliable way, and a government that takes a neutral position in bankruptcy filings and proceedings.

China has defied this kind of “bankruptcy orthodoxy” in managing state-sector restructuring and instead has applied a seemingly inconsistent and ineffective “insolvency by policy” approach over a very long period. From 1984, when the first local experiments with bankruptcy began, until June 2007, when the national law on corporate bankruptcy finally came into effect, bankruptcy proceedings were ruled by experimental and makeshift central and local policies and ad hoc bail-outs.

The regulation of bankruptcies is one of the most controversial issues of economic policymaking in China, starting in 1983 when the issue was first placed on the policymakers’ agenda. Controversies revolved around safeguarding state assets in liquidations and reorganizations and, even more pressing from a political perspective, containing the social and financial repercussions of the SOE insolvencies. Dealing with the massive unemployment and rearranging the social functions of the SOEs

---

15 Booth 2004, op.cit., p.94.
(provision of pensions, health care, housing, schools, kindergartens, etc.) proved to be an extremely difficult task. Solving the SOEs’ problems necessitated a bundle of reforms that threatened to bring about social instability and huge budgetary costs.

The political controversies and drafting processes surrounding the 1986 “Experimental Bankruptcy Law”\(^\text{18}\) and the finalized 2006 “Bankruptcy Law” are rather well documented in Chinese and Western research.\(^\text{19}\) However, one of the most striking and under-explored aspects of Chinese bankruptcy regulation is the extensive use of centrally sponsored, locally implemented experimentation to discover ways of dealing with the social and fiscal repercussions of the thousands of SOE insolvencies. Local experience was used by central policymakers in their arguments about the necessity and content of bankruptcy regulation. Local governments were clearly interested in shaking off the task of paying endless subsidies to unprofitable and wasteful SOEs. At the same time, they had to worry about the consequences of bankruptcy on their political-administrative power base and the potential for mass unrest among workers.

### Table 2: China’s Approach to Bankruptcy: Local Experiments and Central Regulation

<table>
<thead>
<tr>
<th>Year</th>
<th>Local Experimentation</th>
<th>Central Regulation and Law-making</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984-1986</td>
<td>Four municipalities experiment with bankruptcies. Local initiative with informal backing by individual central policymakers.</td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>Formal central approval of local experiments.</td>
<td>National bankruptcy law passed “for experimental implementation.”</td>
</tr>
<tr>
<td>1991</td>
<td></td>
<td>Drafting of revised national bankruptcy law initiated.</td>
</tr>
<tr>
<td>1993</td>
<td>Shenzhen Special Economic Zone (SEZ) adopts local bankruptcy provisions that go beyond the 1986 law.</td>
<td>Drafting of revised national bankruptcy law initiated.</td>
</tr>
<tr>
<td>1996</td>
<td>SETC/PBOC circular on trial implementation of new merger and insolvency procedures in 56 cities (experimental points).</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>State Council supplementary circular on trial implementation of merger, bankruptcy, and re-employment procedures in 117 cities (experimental points).</td>
<td></td>
</tr>
<tr>
<td>1994-2002</td>
<td>Local governments issue implementation measures for SOE bankruptcies based on post-1994 central policies</td>
<td></td>
</tr>
<tr>
<td>Feb. 2005</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


\(^{18}\) Official title: “Enterprise Bankruptcy Law (for Experimental Implementation).”
\(^{19}\) Tanner 1999, op. cit., pp.135-166; Booth 2004, op. cit.
The first attempt at national bankruptcy regulation began with ideologically charged political controversies (1983-86), became stuck in the middle of law-making due to political opposition in the Standing Committee of the National People’s Congress (1986), and resulted in a compromise “Experimental Bankruptcy Law” (1986) that was applied in selected localities and enterprises and never applied nationwide. Bankruptcy regulation remained in a state of limbo until a centrally sponsored policy push initiated a new phase in 1994.

Between 1989 and 1993, China’s courts had accepted only about 1,150 bankruptcy cases whose outcome is not documented in detail. However, in the early 1990s, rapidly mounting state enterprise debts and debt chains among enterprises and state banks emerged as a top-priority problem among policymakers who shared the view that a turn-around and reorganization of SOEs was indispensable. Led by the major economic policymaker in the 1993-2002 period, Zhu Rongji (Vice-Premier 1993-98, Premier 1998-2003), it was decided that a new national Bankruptcy Law be drafted to support the new strategic goal of establishing a “socialist market economy” that had been established by the Communist Party Central Committee in Fall 1993. Zhu Rongji began a virtual crusade against debt chains among SOEs and state-owned banks and managed to raise the issue to the top of the national economic agenda. In this undertaking, Zhu apparently enjoyed strong backing from a broad spectrum of top-level policymakers who agreed that something had to be done about the debt chains. At the same time, there was no consensus on how the drastic restructuring should proceed. In this political context, the “experimental point” method proved to be an approach that broke the national policymaking deadlock.

Starting in fall 1994, a series of central government circulars initiated a new wave of local bankruptcy experiments that was based on what Charles Booth aptly terms an “insolvency by policy” approach:

- In August 1994, the State Council decided to initiate a “Capital Structure Optimization” program in order to achieve “key breakthroughs” in SOE reform. The program included raising new capital, company reorganization, staff diversion, and bankruptcy. The State Economy and Trade Commission (SETC) was charged with formulating specific measures in coordination with eight other departments.
- In October 1994, the State Council issued a circular on trial implementation of SOE bankruptcy in 18 pilot cities (including Shanghai) to test new methods for dealing with the resettlement of employees in insolvent industrial enterprises. Land-use rights were to be sold by auction or tender and the proceeds were to be used for resettling the laid-off workers.
- In July 1996, the SETC and the People's Bank of China issued a joint circular on the trial implementation of mergers and insolvencies of SOEs in 56 experimental units. State-owned banks were ordered to play an active role in debt restructuring.
- In March 1997, the State Council issued a supplementary circular on trial implementation of merger, bankruptcy, and re-employment measures in SOEs, establishing a National Leading Small Group for restructuring work and officially designating 111 additional experimental units. Under the coordination of the State Economy and Trade Commission, a list of enterprises in the trial cities was drawn up for merger, bankruptcy, and rescue.

Through these policy documents, the national government issued general guidelines on the basic priorities and approaches to handle enterprise insolvencies. Local governments were encouraged to

---

come up with innovative solutions to debt restructuring, mergers, closures, and employee resettlement. In the process, the central government selectively extended substantial financial support to local restructuring. Since national social insurance programs were still at an experimental stage when these policies were initiated, bail-outs had to be paid to laid-off workers from local and central coffers and new bank loans. As Jean Oi succinctly points out, local officials, caught between financial and political pressures, had to work out “ad-hoc strategies to either cut job losses or provide for displaced workers.” This approach produced “significant local variation in the timing, speed, and content of reform in different cities” and restructuring therefore remained a “patchwork of solutions that push the limits of reform but then must be reined back to accommodate the political as well as the economic realities that exist in different localities.”

Based on the above-mentioned policy documents, 2,982 SOE restructuring projects involving mergers, insolvencies, and re-employment were commenced between 1994 and 1997. By year-end 1997, 2,393 of these projects had already been completed, among which there were 585 enterprise bankruptcies and 1,022 mergers. In 1998 the experience obtained from the experimental implementation of these policy documents was promoted as the basis for the debt restructuring in SOEs all over China. Knowledge about what could and could not work, and in what kind of context, had been obtained. Local solutions that appeared to the top leadership to be socially and economically feasible were promoted as models from which other jurisdictions should learn. Restructuring then gained momentum on a nationwide scale. To accelerate the restructuring process, the far-reaching decision of the Fourth Plenum of the Fifteenth CCP Central Committee (Fall 1999) ordered banks to increase their bad-debt write-offs so as to support the merger and bankruptcy of large and medium-sized SOEs and to convert SOE debts into equity. Four national asset management companies were created in 1999 for re-packaging and selling the non-performing loans taken over from the state-owned commercial banks. Until 2006, the policies crafted between 1994 and 1998 and the experience obtained through local experimentation in implementation were used as the main guidelines for dealing with insolvency all over China. The number of insolvencies (counting the proceedings formally completed by Chinese courts) increased from 1,232 in 1995 to 3,296 in 2000. Overall, the central government pursued a policy of administratively guided and planned bankruptcy that was shaped and refined based on test-runs in a large number of centrally designated experimental units. In the course of this experimentation process, China’s insolvency system came to constitute a patchwork of overlapping legal and policy documents: the vague, brief, and outdated 1986 “Experimental Bankruptcy Law”; extensive judicial interpretations made by the Supreme Court in 1991 and 2002 to clarify the bankruptcy proceedings in Chinese courts; the series of path-breaking policy decrees issued by the central government since 1994 to deal with specific methods of debt restructuring, enterprise reorganization, and employee resettlement and mainly based on administrative guidance; and local regulations for corporate insolvency and reorganization, with the pioneering role played by the Shenzhen SEZ in testing an approach that was more court-based and market-oriented than the administrative guidance-approach that was prevalent elsewhere in the country. This mix of regulations and regulatory practices left many legal gaps but at the same time provided leeway for innovative policy solutions.

Beginning in 1984, probably the most consistently contested legal issue in Chinese bankruptcy regulation revolved around the priorities in debt settlement. Should priority protection in the liquidation of assets be given to creditors or to employees? Chinese policymaking underwent several shifts in dealing with this particularly delicate issue in a “socialist market economy” that was expected to respect workers’ interests but lacked an effective social security system. Although the 1986

---

23 Oi and Han 2006, op.cit., p.4.
25 Supreme People’s Court data, quoted in Booth 2004, op.cit., pp.95 and 101.
“Experimental Bankruptcy Law” was more creditor-friendly, in reality the administrative practice of dealing with insolvent enterprises favored employees. This was formalized by the 1994 State Council circular that “provided workers’ resettlement rights with a first claim on the land-use rights of SOEs in priority to the pre-existing rights of secured creditors.”27 Thereafter, this priority scheme was followed in thousands of cases. Local experience had clearly demonstrated that, due to rising labor protests and public discontent, it was politically inadvisable and practically impossible to reduce employment in state firms without granting locally negotiated more or less generous compensation packages to the employees.

Further shifts in the priority scheme occurred in the process of drafting the new Bankruptcy Law. A 2002 draft explicitly put the burden of providing compensation to the employees of insolvent enterprises on local governments. In a very employee-friendly October 2004 draft that was circulated during a period of heated debates about social inequity in China, workers were given first priority over the rights of secured creditors, thereby exceeding even the preferential treatment that workers received under the 1994-99 policy decrees.28 However, this policy shift in favor of protecting workers was not retained in the final version of the new Bankruptcy Law, adopted in August 2006, that was presented as consistent with international standards of priority protection for creditors and investors (whereas employee compensation would be implicitly arranged through government bail-outs).

This sequence of rather drastic policy shifts makes it clear that experimentation-based discretionary bankruptcy regulation helped to conceal and manage fundamental political-ideological controversies that were at the heart of the delayed law-making. Policy experimentation over 23 years allowed recurrent adaptations in the application of the basic priority scheme and thereby helped to avoid open policy conflicts. The unorthodox approach to bankruptcy regulation taken by Chinese policymakers manifested the key guiding role that government organs and administrative action play in the management of the state sector: “SOE restructuring in China is not a firm-level decision.”29 Formal bankruptcy proceedings in courts played a minor role during the crucial period of SOE restructuring from 1994 to 2007. Instead, Chinese policymakers used alternative means to reorganize and turn around the SOEs. Generally, corporate rescue measures were not undertaken through bankruptcy proceedings but rather through a variety of flexible, inconsistent, but from a policymaking perspective, much less painful policies. Central and local policymakers shared the view that bankruptcy was neither the politically most palatable, nor the most effective means for dealing with state-sector restructuring. Bankruptcy was merely used as one of several instruments in managing state-sector debts, “along with asset management companies, debt-equity swaps, mergers and acquisitions and other devices, in order to see which works best.”30

A political imperative to avoid sweeping liquidation of state assets through bankruptcy prevented comprehensive regulation and propelled a lengthy search for alternative policy solutions to allow state assets and state control in the economy to survive in a new shape. The process was not about finalizing policy at certain points in time but about repeatedly re-shaping available imperfect solutions until politically acceptable and economically bearable solutions were found and until a conducive economic and fiscal environment could buffer the social repercussions of restructuring.

Whereas policy experimentation was part of a highly politicized and conflict-ridden process at the central level of policymaking, it was predominantly driven by economic and fiscal exigencies at the local administrative levels. Local policy experimentation contributed to the series of makeshift, halfway restructuring measures since the mid-1980s. Between 1994 and 1997, the number of experimental sites for the management of bankruptcies constantly expanded. Thereafter, restructuring

---

27 Booth 2004, op.cit., p.139.
29 Oi and Han 2006, op.cit., p.3.
measures in large SOEs were conducted as part of national framework plans that stipulated which enterprises in which industries should be strengthened, merged, or closed down within a certain period. These plans were then carried out by state investment and administrative allocation. After 1998, decentralized experiments in handling insolvencies contributed to fine-tuning implementation of employee resettlement and financial arrangements, no longer re-defining national policy goals. For the 2005-08 period, a national plan on closures and bankruptcies was drafted and implemented under the auspices of the inter-agency Leading Small Group for Enterprise Mergers, Bankruptcies, and Staff Re-Employment that had been formed in 1997 to coordinate the restructuring process (see Table 2). The 2005-08 plan on bankruptcies was presented as the concluding step in state-guided insolvency management and in dealing with the “historical burdens” of the SOEs. Experimentation no longer played any role. By 2008, it was expected that policy-based insolvencies would be terminated and give way to law- and court-based procedures.

The history of bankruptcy management in China from 1984-2007 reveals that two central institutional elements that are taken for granted in “bankruptcy orthodoxy” simply could not be applied to China’s political economy: a government that takes a neutral, passive role in insolvency proceedings, and an independent, effective court system. China’s insolvency by policy approach generated particular costs and distortions due to the dominant role of government in handling the proceedings and the fall-out of the corporate bankruptcies. Chinese critics point to the massive asset depreciation and asset stripping, the paramount priority given to settling employees’ claims, and the weak disincentives to enterprise managers who saw a policy-based insolvency as a welcome “preferential policy,” not as a sanctioning mechanism.

Distortions and Costs Associated with Experimentation

Policy experimentation has constituted an integral element in the routine mode of crafting reform policies in China over the last three decades. The debates among Chinese academics and policy advisers are particularly instructive to assess the drawbacks and distortions that accompanied the Chinese-style policy experimentation since they drew on policy evaluation over the entire course of China’s reforms and in general they were less influenced by the privatization orthodoxy that dominates international debates about state-sector restructuring. Several key deficiencies and distortions inherent in the experimental point method are stressed in the Chinese debates. At the core, the distortions are caused by the privileged access to public resources that state administrative and economic actors enjoy.

Experimental points facilitate local rent-seeking. Experimentation favors local policymakers and managers who are in a position to instrumentalize central government promotion of experimental points for their narrow, short-term interests. They frequently do not search for generalizable solutions but rather warp the original policy goals. As a major negative example, Chinese academics point to the shareholding reforms in the early 1990s as an opportunity to raise capital without transforming the operations or raising the profitability of the SOEs. Radical critics see the shareholding reforms as a “cosmetic restructuring exercise” that “divided the spoils” among managers, employees, and economic bureaucrats through the selling

---

31 For a critical view of this state involvement and an assessment of the transition to a more market-based system, see Wu Jinglian 2005, op.cit., pp.191-192.
Similar experimental bankruptcy proceedings were instrumentalized by local governments, in collusion with local courts, to clear themselves of the huge debts due to state banks and enterprises in other regions.35

**Preferential policies often failed to produce useful experimentation.** The preferential policies (tax cuts, subsidies, exemptions from national regulations, etc.) that were extended by the central government to officially designated experimental points distorted the incentives, the process, and the results of experimentation. Therefore, many experimental units were nurtured like “weak shoots in a greenhouse” and did not provide any generalizable lessons. The most frequently cited example for such a policy failure is the Hainan SEZ, in particular its Yangpu Zone, that unceasingly demanded subsidies without ever producing viable results. In contrast, the Shenzhen SEZ, due to its close integration with Hong Kong, is widely judged to have been a highly useful reform laboratory.36

*If experimental points are initiated as prestige projects of the top policymakers, they often create wasteful policy crazes.* If experimental points are turned into vehicles for promoting projects of individual policymakers, they are not allowed to fail and they must become successful by any means. Then, even if the experimental point succeeds, the experience obtained will fail in the phase of policy generalization. Personalized and politicized selection of pilots then may result in the blind adoption of fake models and in wasteful policy crazes.37

*Policy experimentation undermines established laws and regulations.* Experimental points exclusively stress reform incentives but neglect to uphold the legal limits of administrative power. Since legislation generally lagged behind the rapid changes in the economy, local experiments regularly ignored or bent existing but obsolete laws. Everything became negotiable in such a reform process, and people therefore lost respect for the law.38 Local bankruptcy experiments without a reliable legal basis are cited by Chinese critics as a negative example. In a large number of cases, the loosely regulated bankruptcy regime during the 1994-2003 period became a means to defraud creditors.39

Experimental point work in SOEs is frequently conducted at the expense of central government coffers without achieving harder budget constraints. In the debates among Chinese scholars, the tax-for-profit reforms of the mid-1980s are cited as a major negative example. In the context of these reforms, local authorities were allowed to determine the effective tax rates by deciding the tax base of each enterprise. When the SOEs ran into financial trouble, local officials “tended to accommodate the demand because corporate income tax revenue was shared between the local and central governments.” The soft taxation scheme was subject to informal bargaining between local officials and SOE managers, at the expense of central government tax revenues.40

---

35 Ding Lu and Zhimin Tang 1997, op.cit., p.95.
38 Ding Lu and Zhimin Tang 1997, op.cit., pp.91, 97; Pan Xining 1995, op.cit., p.29.
From a comparative perspective, several of the deficiencies and distortions cited by the critics do not appear to be problems that are particular to China’s political economy. In an insightful study of policy pilots in Britain since the mid-1990s, Jowell points to many similar dilemmas of policy trials in a democratic rule-of-law system: a lack of independence in implementing and evaluating pilots, pressure to deliver “good news” and to conceal policy imperfections, inequities between beneficiaries and non-beneficiaries of pilot projects that lead to accusations of political favoritism, pilots as a smokescreen for delaying controversial policy decisions, and the vulnerability of even the best-designed pilots to policy shifts or reshufflings among top policymakers.41

Among Chinese academics, the most radical critics reject the experimental point method as an anachronistic instrument of an administrative state that is incompatible with creating a “level playing field” for competition in a market economy and that stands in the way of the creation of market-driven reform solutions.42 The ad hoc, policy-based character of the experimental point method is judged to have been useful in the less complex context of the partial reforms of the past but to be outdated in the present context of systemic reorganization that, according to this critique, can only be achieved through “holistic” policy packages and comprehensive national legislation.43

However, this strand of critique that culminates in statements such as “reform must be spontaneous, it cannot be planned”44 appears to be rather detached from the realities of China’s political economy. In the case of SOE reform, due to the fact that state bodies occupy the role of owners and regulators, administrative involvement, guidance, and accommodation in corporate restructuring cannot be simply wished away. Heavy administrative interference and participation in the restructuring process is inevitable in the Chinese political economy. As a legacy of the former command economy, the rights and responsibilities of government bodies have been subject to political bargaining over the course of China’s economic reforms, and legal limitations of administrative actions are only slowly taking hold.45 In such an institutional context, policymaking cannot be dictated by theoretical or ideological demands for a “level playing field” free of government interference that is impossible to achieve instantly.46 Rather, policy mechanisms that make the best out of the capacities of the prevailing administrative state can function in a productive way in such a political economy.

Proceeding from experimental points to broader policy innovation was possibly the only way to introduce a vital pioneering element into a rigidly organized polity. For a state-dominated economy, China demonstrated a highly unusual degree of policy flexibility. The experimental point method was capable of contributing to substantial policy innovation over time precisely because, with its mix of rigid formal-hierarchical and more flexible informal institutional elements, it fit so well into the logic of the Chinese political economy. The experimental point method served as an instrument for the political management of rapid change that did not destroy but rather utilized existing formal and informal rules of the policymaking game to introduce a strong innovative element into the bureaucratic polity.

In a process of large-scale, rapid, economic and social change that is accompanied by serious political controversies, the experimentation-based approach to policymaking can hardly be blamed for

44 Pan Xining 1995, op.cit., p.28.
45 Ding Lu and Zhimin Tang 1997, op.cit., p.91.
46 From a New Political Economy perspective it is questionable whether a “level playing field” for competition among market participants can exist in reality. Economic opportunities in almost any market (except newly emerging and therefore not yet thickly regulated sectors) are determined to a considerable extent by the political bargaining power of market participants and their influence on market regulation. From this point of view, markets almost always constitute tilted, not level, playing fields.
causing popular disrespect for the law. Applying static standards of legislative consistency to the utterly fluid context of transitional economies and societies is unrealistic and often even detrimental to policy learning and institutional adaptation. Many “shock therapy”-inspired early attempts at economic legislation in post-socialist Eastern Europe implied risky leaps in the dark. The legislators had no clue or no experience about the effects of the laws they issued on real-life economic and administrative actors. In China, experimentation helped to circumvent this pitfall of transition.

Regarding the rent-seeking critique, it should be stressed that local self-interest has been a key mechanism in China to promote overall policy innovation. Policy experiments were particularly successful if they benefited the material and career interests of local officials. They generated diffuse benefits that unleashed the energies of local policy entrepreneurs in economic restructuring and facilitated a broad realignment of interests among China’s administrators.

As a result of fierce lobbying in the selection process, experimental units are often neither representative nor in a situation to provide the best lessons from the experiment. In addition, local governments do everything possible to overstate the positive results of the experiments in their jurisdictions. However, even while failing experiments are rarely terminated in a clear-cut and timely manner and may create considerable budgetary costs, practical successes, not only in one test site but after dissemination to other jurisdictions, are the ultimate litmus test for experimentation. And this litmus test has usually worked to bring to light the meager performance of many fake policy models. For China’s reformists, economic inefficiencies that were also associated with policy experimentation constituted a “necessary transaction cost to maintain political stability and social cohesion.” Thus, despite the distortions and costs it caused, China’s distinctive repertoire of policy experimentation has been an indispensable instrument for promoting and managing systemic change and therefore should be acknowledged as an original policy methodology in the restructuring of a socialist economy.

**Experimentation and Breakthroughs**

In democratic polities that are characterized by extensive institutional checks, regular electoral and leadership changes, contentious public policy debates, and a constantly shifting mix of policy priorities, experimentation is subject to narrow limitations:

> “By the time a policy has reached the statute books, its content (and often its methods of delivery too) have run the gauntlet of parliamentary debate, media examination, pressure from lobbies and scrutiny by committees. Emerging from this process, the final version of a policy may well incorporate numerous carefully worked compromises, which are by then far too complex to be re-opened.”

Under these conditions, pilots that are designed to contribute to developing major policies (before binding policy compromises have been made) are rare. Pilots mainly contribute to optimizing methods of implementation for policies whose content has been hammered out beforehand. This is fundamentally different in China, where policy is developed through experimentation and policy departures are prepared and justified on the basis of prior experimentation.

Ambitious structural reformers utilized experimental programs, such as the insolvency, merger, bankruptcy, and re-employment procedures implemented locally from 1994 to 1997, as an effective

---

48 Oi and Han 2006, op.cit., p.21.
method to introduce ultimately radical policy goals in the guise of incremental trial measures, thereby reducing reform risks while increasing the “controllability” (kekongxing) of the reforms.\textsuperscript{51} Through decentralized experimentation, policy deadlock was frequently overcome and the achievements of the reform were expanded “far beyond what could have been accomplished by top-down initiatives dependent on political consensus among national leaders.”\textsuperscript{52}

An underrated effect of policy experimentation lies in the consequences that come to light only over time and that exceed the initial intentions of the policymakers who initiated it. The economic opening in the SEZs and the 14 coastal cities, for instance, was originally justified by Deng Xiaoping as a limited experiment. Foreign trade and foreign direct investment were not at all intended to increase the competitive pressures on China’s state enterprises at that time. But over the course of the reforms they exerted increasing influence on the policies crafted for SOE restructuring through selective mergers and acquisitions involving foreign investors. Similarly, China’s initial experiments with the transformation of SOEs into shareholding companies were primarily used as an avenue for raising capital. But over the 1990s, policymakers began to use the shareholding system for different ends: first, to change the status of state responsibility in the former SOEs and to find ways to end the state’s “implicit social contract with state workers”\textsuperscript{53}; and second, and belatedly, to improve overall corporate governance with the help of more hands-on shareholders from home and abroad.\textsuperscript{54} In these cases, policy approaches that appeared rather conservative initially were transformed into radical approaches through experimentation and through the learning processes it stimulated. Experimentation therefore often resulted in changes that went beyond original policy conceptions and explications.

Table 3: Foundations of Policymaking for State-Sector Reorganization in China

| Strategy: Beyond the growth imperative, no pre-conceived reform strategy (such as “privatization”) was laid down. The means to achieve economic growth was largely left open. |
| Time horizon: The secure political position of policymakers facilitated institutional displacement and institutional layering (“dual track”: new system outgrows old system) over an extended period. |
| Experimentation: Decentralized policy experimentation and jurisdictional competition (including technically illicit local policy initiatives) were stimulated and tolerated by top policymakers. |
| Experience first, law-making later: Local policy experiments seen by decision-makers as economically successful and politically acceptable were selectively propagated and expanded “from point to surface” in official pilot programs. Economic legislation usually came as a result of this experimentation process. |
| Reserve capacities: In “periods of extraordinary politics” (1992/93, 1997/98, 2001/2) when big reform pushes were undertaken by central policymakers, Communist Party institutions fulfilled a key role in imposing top-level policy initiatives and institutional reorganization. |
| Two-level games: Policy-makers played a two-level game of WTO negotiations so as to intensify transnational adaptive pressures and accelerate state-sector restructuring. |

Some of the key distinctive traits of China’s policymaking approach to state-sector restructuring have been pointed out in this study. The main components are summarized in Table 3. Beyond the growth imperative, there was no pre-conceived reform strategy (such as “privatization”). The means to achieve economic growth and efficiency gains was largely left open. A fundamental difference compared to policymakers in a democratic polity is the time horizon and the secure political position of Chinese policymakers that facilitated “institutional displacement” and “institutional layering”\textsuperscript{55}: Newly emerging elements in the political economy “outgrew” the old elements over an extended period. The

\textsuperscript{52} Rawski 1995, op. cit., p. 1162.
\textsuperscript{53} This is an intriguing point made by Oi and Han 2006, op.cit., pp.14-15.
main precondition for such a policymaking approach, as opposed to policymaking in democratic rule-of-law systems with their recurrent electoral campaigns, is the long time horizon of Chinese policymakers who, in the context of an authoritarian polity, do not have to face organized opposition and electoral competition and therefore can afford to wait for conditions to “mature” and for local experience to accumulate. Moreover, the protracted process of policy learning was made possible by the massive growth in non-state economic activity that reduced the pressure for immediate structural reform in the public sector and thereby provided Chinese policymakers with an unusually opportune environment for learning and adaptation over an extended period of time.

A remarkable feature of China’s economic reform process is the institutional reserve capacity that can be utilized by central policymakers in crisis-driven “periods of extraordinary politics” to impose big reform pushes: 1992-93 in the wake of the dissolution of the Soviet Union and Deng Xiaoping’s forceful reform initiative; 1997-98 in the wake of the Asian Financial Crisis; 2001-2 in the context of the tense domestic bargaining and diplomatic negotiations about the terms of China’s WTO accession. Communist Party institutions fulfilled a crucial role in pushing through top-level policy initiatives and the accompanying institutional reorganization. An “assault-like” style of policymaking was particularly effective in the context of external shocks, such as during the Asian Financial Crisis when resistance against drastic restructuring (packaged as immediate crisis-management and crisis-prevention) was weakened and a top-level consensus on, for example, imposing central control over China’s financial industry was much more easily achieved than during periods of non-crisis routine politics. The response to the Asian Financial Crisis is an important instance in which Leninist institutions provided China’s central politicians with a reserve capacity for initiating structural reform and innovating economic regulation. It was Zhu Rongji, the main economic policymaker between 1993 and 2002, who pursued a centralized, aggressive, and hands-on style that very often consciously attacked the interests of the well-entrenched interest groups. With Zhu’s rise, the conflict-avoiding explorative approach of the veterans was punctuated by selective “assaults against fortified positions” (gongjianzhan), opportunistically using the context of widespread crisis perception for big policy pushes. The main flaw of characterizing China’s reform as “gradualist” or “incrementalist” lies in its failure to capture the transformative policy departures that were prepared and shaped by prior experimentation and the opportunities for “political lightning” that could “transform a long-dead policy proposal and push it to the top of the agenda.”

In China’s systemic restructuring, institutional reserve capacities and central policy pushes were combined with a shrewd two-level game in China’s economic diplomacy. Individual Chinese policymakers played the two-level game of WTO negotiations so as to intensify transnational adaptive pressures and accelerate state-sector restructuring. In agreeing to the strict terms of WTO accession that increased competitive pressures on the state sector, China’s central policymakers moved to create “conditions that would force the SOEs to … restructure and which could not readily be undermined by domestic political resistance.” Through WTO accession, China’s central government agreed to “dismantle many of the measures that had been used to protect SOEs from foreign competition.”

58 Wei Jianing 2000, op.cit.
amounted to a drastic departure from previous trade policies. Although the policy breakthrough was driven by top-level decision-making and external demands, the experience of China’s diverse coastal special economic and free trade zones in benefiting from international integration and furthering systemic restructuring certainly served as an important point of reference and assurance for policymakers to deepen China’s global economic engagement.

Opportunistic timing of major policies has been a constant feature of China’s state-sector reform. The breakthrough for SOE corporatization came in 1997-98 when top decision-makers were willing to entertain radical restructuring measures due to the shock of the Asian Financial Crisis. But at the same time, economic growth and improved tax collection provided the central government and some local governments with the fiscal means to pay a way out for the SOEs from their costly “social functions” and to lay off millions of workers at the expense of government coffers. The years of large-scale SOE restructuring after 1998 benefited from a highly opportune economic and fiscal environment for buffering the painful process through government bail-outs. The Chinese government was in a position to make determined use of this opportunity, not only due to decisive leadership, but also because a plethora of restructuring policies had been tried out in diverse SOEs and localities beforehand, namely in the massive, largely ineffective, yet highly instructive 1994-97 experiments to introduce a modern company system.

Learning *ex negativo*, that is by failed experiments, has played a crucial role in overcoming the piecemeal approach to restructuring pursued prior to 1997. Negative lessons from failed local experiments constitute a much less risky mode of policy learning than the enactment of a national law whose key elements have not been tried out beforehand and therefore may produce unintended adverse results. From the perspective of national policymaking, the mostly limited costs attached to the failure of local experiments appear to be much less significant than the experience and knowledge that failing experiments provide and may help to avoid national policy disasters. Thus, on the basis of the sobering lessons from earlier restructuring measures, reformers found themselves in a position in 1998 to win support for a much more drastic approach to restructuring as soon as the Asian Financial Crisis opened a window of opportunity for comprehensive SOE reform. The turn away from incremental approaches that was initiated in 1998 was much more acceptable and plausible even to reluctant policymakers by the instructive ineffectiveness of the half-hearted and limited institutional reforms that had been tried out in various pilot programs over the preceding years.

The reform path taken in China’s state sector appears to confirm the view that due to institutional complementarities, it is ineffective to restructure only individual elements (e.g., inviting new owners or issuing new corporate governance rules) without simultaneously tackling complementary institutions such as bankruptcy regulation, social security provision, and unemployment insurance. During the early stages of the reform it turned out to be impossible to immediately change the complementary institutions of the corporate sector. However, as soon as fiscal conditions facilitated Kaldor-improving reform (based on comparatively generous compensation of the losers), Chinese policymakers could draw on years of local experimentation with “comprehensive coordinated reform” in a broad spectrum of municipalities. Cumulative experience paved the way for comprehensive reform when the policymaking context changed in favor of drastic policy departures due to the Asian Financial Crisis and WTO accession.

Overall, the Chinese case helps to refine our understanding of how policy regimes shape the making and the results of restructuring efforts. Economic policy performance clearly is not simply determined by the authoritarian or democratic nature of the political system at large. In China’s case,

63 As comprehensive studies by both political scientists and economists have shown, there are no significant and clear correlations between political regime type and economic performance. Cf. Adam Przeworski and Fernando Limongi, “Political Regimes and Economic Growth,” *Journal of Economic Perspectives*, Vol.7 (1993), pp.51-69; Stephen Knack and
the central political authority is a prerequisite for generalizing policy innovations that have been created through local experimentation. But it is the combination of central authority with extensive decentralized initiative and creativity that has made the policy process so productive. A well-established experimentation-based policy cycle has made the search for new economic policy solutions a constant enterprise in China’s polity.

The effectiveness of this policy cycle has rested on narrow policy imperatives (e.g., growth by any means), particular institutions (e.g., the Maoist legacy of decentralized economic administration, combined with the Communist Party’s unitary-hierarchical organization and a fragmentary rule of law) and actor constellations (e.g., technocrat policymakers searching for ways to achieve rapid economic growth while trying to avoid disruptive political conflict) as well as a special bundle of actor expectations. Context-driven expectations are crucial to understand the distinctive behavior of policymakers and experimenters in China’s polity. Whereas policymakers, administrators, and citizens in advanced political economies, such as Japan, tend to view experimental policy departures as risky, destabilizing, and threatening to their stakes in the status quo, political actors in a less advanced, yet rapidly growing economy with a successful reform record, such as China, tend to display more confidence in the benefits that policy change may bring. Therefore, they may perceive policy experimentation more as an opportunity than as a risk. Seen from this perspective, in addition to the distinctive policy process, expectations among experimenters and policymakers about potential gains are a crucial factor in explaining the unusual productivity of policy experimentation in China.

For the time being, Chinese-style state-sector reform has produced socially less disruptive changes than the restructuring processes in post-socialist Eastern European in the 1990s. Institutional and policy experimentation helped to raise efficiency over time while avoiding the leaps in the dark that are associated either with over-ambitious transformative schemes or with systemic breakdown. In most social science analyses of China’s reforms, the effectiveness of experiment-based policy-crafting tends to be underestimated. But it is this particular approach to policymaking that has helped to create a learning authoritarian state and that has facilitated policy and institutional adaptation in China’s economic reforms. The unorthodox modes of central-local interaction in experimentation – experimentation under hierarchy – do not appear on the radar screen of standard policy analysis. This study thus attempts to make our radar more sensitive to detecting unconventional types of policymaking activity that can bring about economic system restructuring in even a rigid bureaucratic and authoritarian polity.