

# **The Subtle Transformation of Contemporary China**

**- A Study of Chinese Political Economy in the Post-Crisis World**

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## Introduction

The emergence of China in the global arena is one of the most important historical phenomena of the 20<sup>th</sup> century. The People's Republic of China (PRC) experienced double-digit growth in the early 21<sup>st</sup> century and maintained it amid global economic crisis. Today China's development affects every major economy around the world. At the same time, more and more other developing countries inspired by China's success are embarking on their own development initiatives. However, people have ambivalent feelings about the Chinese growth. On the one hand, it has brought hundreds of millions of people out of poverty and provided consumers of the world with cheap commodities. On the other hand, the serious side-effects of its capitalist economic development raise doubts about the sustainability of the country's growth. In fact, even the Chinese government is very cautious, if not worried, about the future. In early 2011, when the official data was released that China had surpassed Japan to rank No.2 after the US in terms of its economic size in 2010, there was little triumphalist rhetoric in the Chinese media. The state news agency, *Xinhua*, said that "We should not overestimate our GDP figures, China still has a long way to go to improve its economy."<sup>(1)</sup>

Amid the plethora of commentary and argument about contemporary China, one question is central: what is the nature and future of China's development model, which is defined as "socialism with Chinese characteristics" by the Chinese Communist Party (CCP)? This research paper will address this question by focusing on the CCP's dominant role in the transformation of contemporary Chinese political economy. It argues that given the interdependence of economics and politics, while conditions of economic production and distribution do drive politics in the long run, political structures and decisions also decisively influence economic performance.

My main theoretical approach is the Social Structure of Accumulation (SSA), which is a theory of long term institutional changes and economic fluctuations developed in the context of the American history of the 20<sup>th</sup> century. The SSA refers to the summation of economic institutions, as well as cultural, legal, and political institutions, within which the process of capital accumulation takes place. The SSA matters in the sense that firms need an advantageous external environment to profit. A favourable SSA facilitates growth and stability during a boom period. However, eventually any SSA will decay, and a bust period of stagnation and instability will follow until a new effective SSA can be built. The key of SSA theory is the tendency of each SSA to create the conditions of its own down fall by limiting the potential of future profit and expansion. In the case of China, an SSA analysis reveals the structural limitations and decay of its current economic model, as well as the historical possibilities of the future. In other words, the CCP's successful strategies and the long boom period of the past three decades have brought serious problems, which are starting to undermine the sustainability of the Chinese growth. This research paper will pay close attention to the CCP's stance and options when dealing with these new challenges.

### A Historical Review: Two Paradoxes

When the Berlin Wall fell and the USSR collapsed two decades ago, many believed that China would become a neoliberal market economy after a crumbling of the CCP's legitimacy. However, twenty years later, the CCP's absolute position of power remains unchallenged. And thanks the booming economy, the party today enjoys decisive bargaining power on various international issues. Ironically, this fact contradicts the "common sense" that a successful capitalist economy requires, or will eventually bring about, a liberal democracy. So, there emerge two interrelated paradoxes. First, why was the CCP not overthrown like its counterparts in Eastern Europe and Former Soviet Union countries (EEFSU) after the Cold War? Second, how has China's capitalist economy been successful, at least until now,

under the rule of an authoritarian regime? These two questions are the key to understanding the nature of the current Chinese SSA. This section will answer them by briefly reviewing the Chinese political economy after 1979.

When comparing the fates of communist parties of the post-communist period, it is very important to keep in mind that the CCP was facing drastically different economic challenges than communist parties in EEFSU countries were in the 1980s and 1990s. Among the transition economies, on the one hand, most EEFSU countries suffered from significant declines in output and continued economic turmoil.<sup>(2)</sup> On the other hand, China has enjoyed extraordinary growth since “reform and opening”. A common explanation for this is that the USSR reform failed because it involved shock therapy with mismanaged fiscal and monetary policies, while the Chinese reform was gradual, and started in the economic realm with the political structure remaining stable.<sup>(3)</sup> This interpretation, however, neglects some profound structural differences between the two nations which were responsible for the different outcomes of the reforms.

In former socialist societies, state-owned enterprises (SOEs) were extensively protected and heavily subsidized. The reformers of those nations claimed that the workers lacked motives to improve productivity, and workers’ income was considered to be higher than their marginal product. So, according to mainstream economics, one central task of post-communist transition was to privatize SOEs in the name of raising productivity and releasing budgetary burdens. In the case of Russia, which had 93% of its labour force working in the state sector during the 1980s, even the agricultural sector was highly modernized, and workers on farms were as well subsidized by the state as workers in factories.<sup>(4)</sup> As a result, most Russians were seriously weakened by the removal of the socialist system. The collapse of demand for output after 1991, particularly of heavy industry like defence from other EEFSU countries, further weakened the economy.<sup>(5)</sup> Accompanied with macroeconomic mismanagement and

political corruption, the transition process in Russia resulted in an overall economic collapse and social discontent. Naturally, the Soviet Communist Party lost its credibility in a neoliberal reform that worsened the socio-economic condition of most people.

In contrast, China had 71% of its total work force in the traditional agriculture sector at the beginning of its reform in the late 1970s. While producing over half of national output, the state industry sector only employed 18% of the labour force.<sup>(6)</sup> In other words, before the transition to a capitalist market economy, the majority of China's population was engaged in pre-industrial agriculture, while most EEFSU countries were already highly urbanized. Due to this structural difference, the main challenge faced by China was more like the classical problem of development of a dual economy, rather than restructuring of heavy industry. During the past few decades, internal migration in China transferred hundreds of millions of labourers from traditional agriculture to productive industries in urban areas. This huge reserve army of labour from rural areas was vital for the formation of the current SSA that facilitated capital accumulation and economic expansion. As even the real wage of migrant peasant workers in sweatshops improved, this proletarianization process rewarded major groups in China in its initial stage in terms of absolute income. Though the call for capitalism did not originate from the workers and peasants per se, it was carried out relatively smoothly without serious resistance.

While developing the private economy, the restructuring of Chinese state industry did not happen until five years after rural liberalization and opening to international trade and capital in 1979. In fact, the reformed state industry in China did not perform as well as the rest of the economy during the same period, but it was not big enough to compromise the overall boost of Chinese economy.<sup>(7)</sup> China enjoyed the "advantage of backwardness" that rapid growth was possible without dealing with the troubles in restructuring the state industry as it only employed a relatively small portion of the population. Of course, the current SSA emerged with many adverse effects that became obvious in the long run, which

will be discussed thoroughly later. For the moment we note only that it was neither shock therapy nor gradualism, but different domestic economic structures prior to reform that led to different economic performances, which in turn determined the courses of political changes in the contrasting fates of the EEFSU and China. The steady growth of the overall economy stabilized Chinese society and obviated any strictly economic need for political reform. So far, the first paradox of why the CCP was not overthrown like its counterparts in EEFSU countries is solved: the relative backwardness of China allowed an emergence of an SSA that facilitated fast economic growth and ensured relative social and political stability.

Rather than being resistant to capitalist development, the CCP actively engaged in the economic reform and social transition. It successfully remained at the centre of the formation of the current SSA, while communist parties in many other countries in the socialist camp were marginalized by the rise of capitalism. During the 1980s, the CCP mainly concentrated on rural reform before the dismantling of the welfare system in the urban SOEs, and petty bourgeoisie (restaurant owners, barber shop owners, etc.) and craftsmen flourished from villages and towns all across the country. During the 1990s and 2000s, the CCP's policies changed direction toward urban-oriented large scale enterprises and promotion of export-oriented manufacturing, and the economy continued to expand. At a micro level, there is an alliance formed between the political and economic elites throughout the three decades of opening and reform. A simple statistic says it all: 90% of Chinese millionaires are the relatives of high-ranking government officials.<sup>(8)</sup> There is no split between the political leaders and economic elites as they shared common interests in the context of the formation of a capitalist SSA.

On the one hand, the Party officials needed economic growth to ensure political stability as well as their own wellbeing, so they actively cultivated a pro-business environment. On the other hand, the private sector relies on favourable policies and support from the government to prosper, and shows very

little interest in any political reform that might disturb the favourable conditions of the status quo.<sup>(9)</sup> Under such circumstances, the stability of the political structure that centred on a pro-business authority even became necessary for long term economic expansion. For these reasons, the political economic situation in China is sometimes referred to as state capitalism, as opposed to neoliberal capitalism with laissez-faire government. Now the second paradox of how can a capitalist economy be successful without a liberal democracy is also solved: rather than resisting or being marginalized by the new economy, the CCP's firm support for corporate interests is a key component of the current Chinese SSA that facilitated economic growth.

Another feature of this state-capitalist relationship is relative decentralization at the local level. As Dickson illustrated, "crony communism" in China is distinctive when compared to the situation in post-communist Russia or some authoritarian Asian countries, where societies are dominated by central bureaucrats and their families, and the economies are controlled by a handful of oligarchs. In contrast, the vast majority of privately-owned factories in China are small or medium in size, focusing on very narrow markets such as cigarette lighters, or cell phone assembly, etc. This robust but highly diffused private sector absorbs over half of the work force. The interdependence between government officials and private owners mentioned previously mainly takes place at the local level.<sup>(10)</sup> However, this "decentralization" is less obvious at the national level. While releasing the less important sectors to private development, the central government of China is in direct control over "key" industries, such as petro, railway and telecommunications. State-owned brands still account for an estimated 70-75% of the \$280 billion total combined value of the top 50 brand names in China.<sup>(11)</sup> Not to mention departments like military and banking, over which the CCP still enjoys absolute power. This enables the CCP to effectively implement industrial policies that function as "levers" for subsequent development in the overall economy through backward and forward linkages between various industries. The best example

of this in China is government initiated infrastructure and state-funded R&D. Beijing's "Grasp the Big and Release the Small" principle serves political stability, as the dispersed nature of the private economy makes large scale collective bourgeois political action aimed at political liberalization originating from the bottom very difficult. However, this double layer structure, centralized at the top and dispersed at the bottom, also includes the possibility that certain policies originating from the top may not be fully implemented everywhere. The significance of this structure will be addressed in more detail later when discussing the CCP's attempt to build a new SSA.

While resolving the two paradoxes, major characteristics of the current SSA that brought thirty years of capitalist growth and stability become clear. The CCP managed to preserve its authoritarian regime by actively integrating its political power with the capitalist economy that raised the overall income level, which in turn further facilitated economic growth and ensured social stability. On the one hand, the CCP holds control over key areas of the economy at the national level, and shares the common goal of expanding the capitalist economy with the business community. At the local level, government largely colludes with the diffuse business sector, which relies on the CCP's support to earn profit. This has been especially true since former chairman Jiang Zemin's "Three Represents" slogan was added to Deng's "Opening and Reform" as central party doctrine in 2001. The communist party, that should only represent workers and peasants in theory, has largely bound itself to the emerging capitalist mode of production and new social elites, which are referred to as the "most productive forces and most advanced culture" in Jiang's doctrine. Through the economic reform, the CCP has effectively prevented the formation of any organized opponents which might potentially challenge its power. The size and influence of any groups outside the party, whether they are formed by the business class, intellectuals, religious people, or workers, are seriously limited and closely monitored. Capitalist economic growth in



the vision of “modernization and rejuvenation of the nation” has become the main source of the CCP’s legitimacy in the post-communist era.

### By-Products and Crisis of the SSA

Five favourable conditions characterise the current Chinese SSA: human resource and industrial development of the pre-1979 period, large size of labour reserve, pro-business policies, government sponsorship in “key areas”, and an open world market. For the first point, China made considerable achievements in terms of human and industrial development from 1949 to 1979, which are usually neglected by mainstream economic commentators. For instance, compared to many other developing countries during the same period, China enjoyed much larger improvements in the adult literacy and life expectancy, which are key to labour productivity, due to social stability and Mao’s populist policies.<sup>(12)</sup> Also, the state’s industrial policy enabled China to have various heavy industries that are essential for economic and political autonomy. For the second and third point, consider the example of the “Residence Registration System”, which has been enforced by the CCP since 1950s for socialist central planning, but became a system of discrimination and deprivation in the new era. According to residential laws and policies, migrant workers working in cities are denied access to health care and job protection as city dwellers. Their children cannot receive education in urban schools without significant amounts of extra tuition fees. Nowadays these migrant workers are 250 million in number, while the ratio of city residence increased 13% in the past decade, according to the latest National Census Report released in April 2011.<sup>(13)</sup> Their situation duplicates that of undocumented Mexican workers in the US in a lot of aspects, which also benefited employers with unfairly cheap labour. For the last point, as mentioned before, the CCP retains strong control over more important industries and keeps investing in key areas, such as infrastructure, which are essential to overall economic growth. The last point is marked by the re-establishment of diplomatic relation between China and America in 1979 in the context of the Cold

War, as well as China's entry into the WTO in 2001. The reconciliation with the West and integration into the world capitalist system opened the world market to Chinese commodities in the 1990s and 2000s.

With those favourable conditions of the current SSA, China has developed a rapidly expanding economy composed of three sectors. First, a rural agriculture sector that is still very large in terms of population (40% of total population and 55% of total working population) but relatively trivial in share of GDP (contributed less than 10% in 2010).<sup>(14)</sup> Second, a private sector that mainly relies on export-oriented and low-value-added manufacturing, as well as growing service sector. As the primary engine of economic growth, this part of the economy has doubled its absolute size in the past 5 years (2006-2010), and now makes up to over half of the GDP (statistics vary, however, the majority of them are within the range of 50%-65%).<sup>(15)</sup> Also, the private sector contributes to more than 90% of all new urban employment by having created over 10 million jobs annually in recent years.<sup>(16)</sup> Third, a state-led sector concentrating on strategic areas that are identified as the lifelines of the economy. SOEs now only employ around 30% of China's non-agricultural workers, and account for less than 40% of the country's GDP.<sup>(17)</sup> The significance of these two figures is, however, affected by the fact that SOEs are becoming larger in scale, thus less in number. Here we argue that the current SSA is decaying. The economic growth will slow down under the current model, and this will inevitably pose new challenges to the CCP, whose governing legitimacy largely rests on economic performance.

### International Market

According to calculations by Hung Ho-Fung, China's exports stand at 40% of total GDP today.<sup>(18)</sup> Due to exponential increases since China's entry into the WTO in 2001, exports have become an engine of Chinese growth. Over half of exported Chinese commodities are sold in the US and EU,

while most of China's trade surplus is from Sino-US trade (180-230 billion USD in 2009, statistics vary).<sup>(19)</sup> However, after the economic downturn that started in the US real estate market in 2008, and following the debt-crisis in the Euro zone beginning in late 2009, the aggregate demand for Chinese manufacturing has been seriously undermined. Comparing the data of 2008 and 2009, China's exports to the US decreased 12%, and China's total export to the world decreased 16%.<sup>(20)</sup> In 2009, the trade surplus fell by roughly a third, and further narrowed by 6.4% in 2010. The major reason for these changes is the stagnation in international demand, especially in global North. The 16% decrease of exports led to an 11% decrease of imports of raw materials, intermediate products, and high-end machineries, as Chinese manufacturers ceased to expand production.<sup>(21)</sup> This overall trend toward a more balanced trade is also a result of rising prices of Chinese imports, especially of raw materials. For instance, the textile industry in China has to deal with a 150% price increase of imported cotton from 2010 to 2011.<sup>(22)</sup>

International demand for Chinese goods will not necessarily continue to shrink, as trade figures indicate that there was a moderate recovery of Chinese exports in 2010 to the US and EU.<sup>(23)</sup> However, while some argue that this is a signal of a total recovery of the world economy, for others it is merely a bounce at the bottom. Even if we expect the best to happen, it is unlikely that there is room for China to enjoy another decade of 25% average annual export growth as it did from 2000 to 2008<sup>(24)</sup>. Total exports would need to triple in 5 years, and nonuple in 10 years, in order to maintain that pace of increase. Considering the example of the US-Sino trade, such an expansion of American imports of Chinese goods in the coming years is impossible as debt-fuelled consumerism and current account deficit cannot be sustained. To make matters worse, the catch-up economic model of export-oriented labour-intensive manufacturing is now used by more and more other Asian countries, such as India, Vietnam, and Indonesia. There is much more competition for limited international markets today than in

the 1990s and 2000s. In general, as international markets cease to absorb more and more Chinese commodities as they used to, Chinese manufacturers face the problem of growing excess productive capacity. Last but not least, partly due to extensive reports in the media about Sino-US trade deficit and exchange rate disputes, one tends to exaggerate the effect of the US market on the Chinese economy. Exports to the world have been boosting Chinese growth, but that does not mean that China's economy is entirely dependent on the US market. As will be illustrated in the following aspects, insufficient international demand will seriously hinder the Chinese economic growth, but it is by no means the only problem China is facing today.

### Industrial Structure

China's comparative advantage is in low-technology labour-intensive manufacturing for both the domestic market and the international market. Typically China imports components that have the most value-added, such as integrated circuits and CPUs, from countries like Japan and America. Then China assembles these electronics, and a large portion of these final products are exported to OECD countries. So China's biggest import goods category and export goods category are both electrical machinery and equipment.<sup>(25)</sup> However, this industrial structure entails that the massive export manufacturing only brings very small value added to Chinese manufactures.

Yuqing Xing and Neal Detert's report on the production of the iPhones, all of which are assembled in China today, clearly illustrates this international production specialization.<sup>(26)</sup> The iPhones are designed by Apple in America, while the actual production of more sophisticated parts of them takes place in other countries, including South Korea, Japan, Taiwan, Germany. Then the PRC imports these core components and re-exports them as the final product to the US and the rest of the world. The assembling of all the iPhones is conducted in Foxconn, a company from Taipei located in southern PRC

(this company recently moved to Hebei province in Northern China, which will be discussed later). The contribution of workers on the assembly line accounts for only 3.6% of the total manufacturing cost of the iPhone. Ironically, according to the conventional method of calculating trade figures, the iPhone alone contributed US\$1.9 billion to China's trade surplus with the US in 2009, while less than 4% of the total value added stays in China.<sup>(27)</sup>

On average, according to Robert Koopman from the US International Trade Commission, only half of the value added of Chinese exports eventually stays in China, which is much lower than developed countries.<sup>(28)</sup> This disadvantage in industrial structure limits Chinese worker's income, as well as Chinese manufacturer's investment in R&D. The small size of their revenue makes Chinese firms vulnerable to fluctuations in the external environment, which was manifested in the current economic crisis. This also implies that a given exchange rate appreciation is likely to have a smaller effect on China's trade surplus than for other countries. Of course, this structural disadvantage embedded in international division of production under the law of comparative advantage in the global market is also widely seen in other developing countries.

### Demographic Transition

Due to the introduction of modern technology and political stability, China was at the second stage of demographic transition in the 1950s and 1960s, while there was high birth rate and low death rate. Soon after the introduction of the "One-Child Policy" in 1978, China had already reached a low fertility rate by the 1980s.<sup>(29)</sup> A direct relationship between demographic change and economic development for China results from the combination of large population and high working-age ratio. A rise in working-age percentage can increase income per capita even if output per worker remains unchanged.<sup>(30)</sup> This higher working-age percentage was brought about by a decline in the fertility rate,

which reduced the number of youth dependents in society and increased female labour force participation at the same time. The large working age population also created higher savings rates, which promoted the accumulation of physical and human capital, such as education, and technological progress. This saving rate peaked around 2007 at about 22% of total GDP.<sup>(31)</sup>

As the demographic transition evolves, China will meet a turning point in ten years with working age ratio reaching its peak and saving rate continuing to shrink, as indicated by the Sixth National Census Report released in April 2011. It also predicts that total population of China will reach its peak in three decades.<sup>(32)</sup> On the one hand, Chinese people will benefit more from fast economic development as population growth no longer evaporates total income growth. On the other hand, the stabilization of the fertility rate at below-replacement levels in China implies an increase in the old-age share and thus a decline in the working-age share in the foreseeable future. The same report also indicates that, by 2050, 38% of the total population of China will be 65 years or older, up from 11% in 2011. That figure will be much higher than that of Japan, whose demographic problem has long been known. In contrast, India, another major emerging economy, will enjoy a relative advantage over China with the benefit of a large labour reserve for a much longer time. In 2030, India will surpass China in working age population; in 2050, India will have 170 million more people of working age than China.<sup>(33)</sup>

In general, the current Chinese economic growth is likely to be challenged by this increased percentage of non-working population. Many people suggest that Chinese economy will stop to grow when its demographic dividend is depleted and the wage level is pushed up to squeeze profitability in the foreseeable future.<sup>(34)</sup> Of course, there are ways to temporarily neutralize this negative effect, such as encouragement of further female labour force participation, dismantling retirement incentives to keep people in the workforce for a longer time, etc. However, a more fundamental solution lies in improving productivity so that the increased per unit cost for manufactures can be kept down. This improvement

would require transforming the economic mode from labour intensive manufacturing to a more technologically advanced economy.

### Negative Externalities

The economic development in China has brought serious negative social and ecological externalities. Compared to other industrialized Asian countries, China has not achieved equity along with its growth. According to David Beim, wage/GDP ratio in China decreased 9% during the past two decades, while productivity and profit rate went up rapidly.<sup>(35)</sup> Social inequality has been increasing throughout the 80s, 90s, and 2000s. Official data from the National Bureau of Statistics indicates that, China's per capita GDP rose 7 times during the last 3 decades, but the Gini Coefficient also rose from around 0.3 to 0.47. Now the poorest 10% of people control 1.4% of the country's wealth, while the richest 10% control 45%.<sup>(36)</sup> To make matters worse, due to the integration of economic wealth and political power, there has been serious corruption among CCP officials. At the same time, there is endless labour unrest, ethnic conflicts, and human rights demonstrations in China. Social discontent undermines the people's faith in the current political economic structure. More details on this issue will be addressed later.

Capitalist economic growth in China has also resulted in significant ecological problems and threatens the sustainability of China's development. In 1961, China was using 80% of its ecological capacity, 100% in 1971, 128% in 1981, 161% in 1991 and 195% in 2002. In other words, China's depletion of energy and the environment is double of its bio capacity. As a result, bio capacity has declined by 23% over the 1961-2002 period to 77% of its 1961 level.<sup>(37)</sup> Today China now consumes more fossil fuel than any other country in the world, though per capita consumption is still much lower than the US. China imports more than half of its oil, and the CCP has established partnerships with third world oil exporters. But as an oil importing country, China has to deal with continuously rising petro

prices, which affect manufacturing, construction, and transportation. Especially if the OECD countries' economies resume momentum, the black gold will be even scarcer.

Based on the various problems stated above, the current SSA that brought China thirty years' of growth is decaying. Chinese industries cannot find enough markets internationally or domestically to absorb their expanding productive capacity, and resources and labour are much scarcer nowadays. Accompanied by a gradual appreciation of the Yuan, Chinese manufacturers (mainly medium and small in scale) are facing a serious squeeze of the profit rate that will likely to worsen in the coming decades. A mass scale of shutdowns were witnessed in export manufacturing zones after the global economic downturn.<sup>(38)</sup> For instance, many small and medium-scale coastal textile factories who used to have the profit rate of 3% to 5% were running at a loss and were forced to shut down in coastal provinces like Guangdong and Zhejiang.<sup>(39)</sup> The worst estimate is that 20% to 30% of private firms in those regions shut down or went bankrupt in 2008-2009.<sup>(40)</sup> Politically, the overall support for the CCP has been declining in recent years due to social polarization and environmental degradation, which seriously undermines the stability of social development and efficiency of the current economic model.

Note that the economic troubles illustrated above has not fully revealed itself so far, as major macroeconomic indicators look good at the national level at the moment. China's GDP sustained its high growth in 2009 and 2010, despite the stagnation in exporting manufacturing. However, if investigated further, that is largely due to a 33.3% surge in government oriented investment as a response to the global economic crisis.<sup>(41)</sup> The government's expansionary policies contributed to robust stock and real estate market, which seem to indicate a healthily growing economy. This boom in financial sector is also fuelled by capital fleeing away from the manufacturing due to falling profit rate mentioned above, as well as "hot money" from international investors.<sup>(42)</sup> While the economic growth appears to be strong on the surface, the embedded structural problems discussed previously left unsolved. Moreover, as the



financial market continues to grow, it tends to attract more capital away from industrial production. These over-heating areas boost up the overall inflation rate, which further erodes the wealth of middle-income people, thus triggering more popular discontent. In general, even if a total crisis of Chinese economy is still at an embryonic stage, it is obvious that the current SSA is not sustainable. With its enormous political and economic leverages, the CCP has the ability to adopt favourable policies to prevent a total economic collapse in the foreseeable future. If the CCP once again actively participated in the formation of a new SSA that could facilitate sustained economic growth, it is likely that CCP would preserve political legitimacy and social stability.

### Transformation: the Party's Grand Design and Its Contradictions

This part of the research will focus on the CCP's role in two major aspects of the formation of a new SSA that will give birth to another boom period: expanding the domestic market and upgrading manufacturing. In fact, the recently released "China's 12th Five-Year Plan", which is China's official guiding document for industrial and economic policies, explicitly identifies these two points as key to "a new phase in growth".<sup>(43)</sup> However, here we do not assume that a new SSA that leads to "a new phase of growth" will be realized easily. Failure in either one of the two aspects will result in a stagnation of economic growth, which will eventually bring social instability. At the same time, there are inherent limitations to the CCP's willingness and ability to pursue such a transformation. More details will be investigated in the two parts below.

#### Domestic Market

As analysed in previous sections, a transformation from export-oriented manufacturing to domestic-consumption economy is necessary. An expanded domestic market would diminish the PRC's economic dependence on the international market and at the same time allows for accumulation to

continue. Expanding domestic demand would require a raising the purchasing power of the mass. This is a fundamental reversal of the current SSA, which depresses household consumption. This process of increasing domestic demand/consumption will not likely to appear in the American model of financing debt through international borrowing, as the RMB does not enjoy the same status of global currency as USD. So a more egalitarian distribution system is the only feasible solution, which will also stabilize the CCP's absolute political status. It shall resemble Fordism in the US in the 1950s, in which workers were paid higher wages so that they could afford the products and services they produced, leading to a full utilization of productive capacity. As will be shown in the following paragraphs, the CCP is playing a contradictory, yet decisive role in this process.

Currently, both workers and private enterprises are still in a fairly dispersed condition. The central government still has considerable leverage in repressing struggles from the working class as well as making some compromises. This is a crucial feature of the contemporary Chinese political-economy compared to Western liberal economies, where the business sector enjoys a much larger influence on government, rather than the other way around. In fact, the Chinese state started adopting various measures to decrease urban/rural, coastal/inland, capitalist/labour inequality in recent years, especially under the Hu/Wen administration. "A more egalitarian distribution system and expanding domestic demand" appears as a central point in China's 12th Five-Year Plan (2011-2015), which is the official outline of the state's industrial policies. In fact, Hu/Wen's populist cabinet, in contrasted to Jiang/Zhu's elitism, started in 2005 to fuel domestic consumption by boosting the disposable income of peasants and migrant workers in order to achieve a "harmonious society of Chinese socialism". The first wave of such initiatives included the abolition of agricultural taxes and a rise in government procurement prices for agricultural products in 2005.<sup>(44)</sup> This slight improvement in the traditional sector slowed the flow of migration to the cities, and resulted in a sudden pressure of labour shortages in coastal zones mentioned

in previous discussion. In April 2011, Beijing passed the law of raising minimum income required to pay personal income tax from \$315/month to \$450/month. Such an initiation is largely considered to be related to the massive Shanghai truck drivers' strike earlier this year.<sup>(45)</sup> Of course there is doubt as to whether these new policies are fully implemented in the, but at least the workers are getting more and more legal safeguard which could be utilized to protect their rights and interests.

However, the current scale of economic compromise with the working class is not large enough to fulfill a total transformation of the SSA toward domestic consumption. As even with some "make-up policies" mentioned previously, the wage level of Chinese labour is still very low.<sup>(46)</sup> As noted previously, the pace of the overall wage increase has been much lower than the high GDP growth, which means the ratio of household income and consumption to GDP has been worsening. The wage increases also are largely neutralized by the rising cost of living. More importantly, these limited compromises are the CCP's reluctant reactions to rising social unrest in both number and scale. The state's protection for labour interests is only seen when mass discontent is rocking the boat. To put the degree of social unrest in numbers, the *China Labour Bulletin* estimates 127,000 mass incidents in 2008, and about one-third of these are thought to be labour-related.<sup>(47)</sup> It is these rising labour strikes, violent or peaceful, that threaten political stability and force the CCP to take conciliating policies. In general, now the CCP has to deal with "three revolutionary groups" that have emerged in contemporary China.

The first potentially revolutionary group is that of migrant peasant workers, who are mainly employed in the practically proverbial "sweatshops" in China's manufacturing heartlands. They are 250 million in number, and suffer from the poorest working conditions and lowest wage levels.<sup>(48)</sup> For example, in the first quarter of 2010, twelve Foxconn (the company mentioned previously that assembles the iPhones) workers committed suicide due to low wages, poor working conditions, and psychological trauma.<sup>(49)</sup> This tragedy provoked a national campaign against sweatshops in China, as

well as criticism of the government for allowing such a thing to happen. Intermediated by local government, managers and owners of the company agreed to increase wages and decided to relocate the factory from Guangdong province on the southeast coast to Hebei province in Northern China, where the average wage is 25% lower. The CCP facilitates this movement of manufacturing to inner land areas, expecting this internal migration to temporarily cool down the sharp conflict.<sup>(50)</sup>

Chan & Ngai's 2009 research of a migrant worker strike in a Taiwanese factory in southern China reveals some important characteristics of contemporary migrant workers' movement in China. When the workers started the strike and protested on the street, "they were stopped after ten minutes on the highway by hundreds of police, military police and government-employed security guards. The local labour bureau officials persuaded them to return to the factory, and promised that they would come to help negotiation." Finally, a three-party meeting – migrant workers, factory managers, and government (local labour bureau officials and the police) – was held, and the factory owner promised longer breaks and wage policies that would fully comply with the law. The protest seemed to have successfully achieved its goal. However, worker representatives which had been arrested were not immediately released by the local authorities, and they never returned to the factory. The workers retreated to their un-unionized state after the strike. Moreover, the language of "class" was not used during these strikes among migrant workers.<sup>(51)</sup> In general, the level of migrant worker mobilization remains at an immature stage at this moment. The CCP has been very determined to keep migrant workers, as well as other groups of people, from being organized, while at the same time facilitating limited compromise with them to ensure stability.

The second potentially revolutionary group is that of workers in SOEs. They used to enjoy abundant welfare in the pre-reform era, including health care, housing, education, and work protections, which were gradually dismantled after the economic transition. These workers also witnessed the crime

of embezzlement during the process of Management Buy-Outs in some Chinese SOEs, as former factory managers misappropriated the state property through their privileges and insider connections. The de-facto elite control of these SOE properties started in the 1990s and attained de-jure status in the 2000s.<sup>(52)</sup> Though their number is small compared to migrant workers in labour-intensive manufacturing, they are predominant in strategic heavy industries. Also, there is a higher degree of class consciousness among urban SOE workers.<sup>(53)</sup>

One well-known recent case of resistance on the part of SOE workers was the trial of a worker's rights activist, Zhao Dongmin, in 2010, who served as a coordinator of a local Mao Zedong Thought Study Group. Zhao investigated cases of SOE property being sold illegally, which resulted in the cut of workers' benefits in the city of Xi'an. After leading a rally against these scandals and asking for the legal rights of the local SOE workers, he was immediately arrested by local police for "disturbing the public order" in mid-2009. He was eventually released after the trial in October 2010, thanks to a nationwide popular campaign. Notably, the SOE workers were effectively using the PRC Constitution and CCP Charter, which fully recognize the rights of working class under a socialist system, to ask the authority to release Zhao.<sup>(54)</sup> This strategy pushed the CCP into an awkward situation. On the one hand, it needed to crack down on any organized challenge to the Party's status, which is also essential for its members' economic privilege. On the other hand, by punishing pro-socialist movements, the CCP denied its own party doctrine, and thus undermined its own legitimacy. This portion of workers with a higher level of class consciousness is likely to play a bigger and bigger role in organizing the Chinese working class as a whole to achieve a more egalitarian economic system in the future.

The third potentially revolutionary group is that of the college and university graduates. For common Chinese households, education of their children has been regarded as the path to moving up the social ladder. Many consider the ability of getting into university an evidence of superior intelligence

over less smart people who have to work in factories or agriculture. Young people, as well as their families, expect to realize “middle class”, or petty bourgeois, living standards through post-secondary education, as compared to their parents’ miserable condition as workers and peasants. Key components of such a “Chinese dream” include a professional job in cities, and ownership of an apartment and a car. However, their sweet dreams are crushed by ruthless reality. While the average income of peasant workers has increased from 700RMB/month to 1200RMB/month since 2003, the wage level of university graduates has remained unchanged at 1500-2000RMB/month (statistics vary).<sup>(55)</sup>

A major reason for this disparity is the continuous growth in university enrolment. According to the Sixth National Census Report released in April 2011, the percentage of people having post-secondary education tripled in 10 years from 2000 to 2010.<sup>(56)</sup> In recent years, more than 6 million university graduates entered the job market annually. In fact, this could be a major advantage for China to upgrade its industries and build a consumption-oriented economy. Unfortunately, due to the current industrial structure discussed previously, the Chinese economy cannot produce enough jobs for that number of people with higher education.<sup>(57)</sup> Accompanied by a rapidly rising cost of living, especially the price level of urban housing, their real income has actually decreased. As these young people realize that they belong to the deprived masses, their political views inevitably start to change. Compared to the factory workers, traumatized university graduates can be more effective political agents in certain aspects. In the recent past they have struggled fiercely over the control of the internet with the authorities, for example. Initially, the flow of information was promoted by the government to facilitate economic development. However, as more and more people start to use the internet for political purposes, the CCP has to spend astronomical amounts of money on internet information control. Indeed, thanks to their education, young people are always able to break the “Great Firewall”, and a considerable portion of China’s popular movements today are organized through the internet.<sup>(58)</sup>

On the CCP's part, there are obvious inherent limitations in terms of its ability and willingness to raise the income level of the working class in a new SSA. The egalitarian distribution system described in the 12<sup>th</sup> Five Year Plan may not be implemented by Party members at the local level. A recent example of this is the case of controlling rapidly rising real estate prices, which is widely seen as a tool of eroding working class income. The Party Central Committee explicitly announced the importance of controlling housing price in building a "harmonious society" in both the 11<sup>th</sup> and 12<sup>th</sup> Five Year Plan. However, the official media, *People's Daily*, reported that "49 Chinese cities have defied the central government order" in cooling down the housing market in early 2011. Such a resistance is largely a result of local governments' reliance on the taxation from the real estate sector, as well as corruption between local officials and real estate developers.<sup>(59)</sup> This interdependence of CCP officials and the business sector inevitably entails pro-business bias, which renders a theoretically optimum socio-economic restructuring hard to realize.

Currently, the Chinese government enjoys enormous leverage and skills to strangle social unrest well before the situation gets out of control. However, as the size and maturity of Chinese workers continue to grow, there will be a fundamental change in the balance of power in the coming decades. Even in the short run, their struggle for economic and social fairness is making it more and more difficult for the elites to impose an exploitative economic structure upon them. The 2010 government spending on "domestic security", which includes funding for police, jails, courts, etc., had already surpassed the spending on national defence.<sup>(60)</sup> This reveals that the current SSA is becoming increasingly costly to maintain as a production system. Minqi Li suggests that there must be massive income redistribution from capitalist income to labour income and social spending by the amount of about 20% of entire GDP.<sup>(61)</sup> This can only be implemented through either a transfer of state power or a fundamental redirection of CCP policies.

## Domestic Innovation

The second key aspect of the new SSA is domestic innovation. The government's effort to promote innovation in Chinese industries aims to break the country's dependence on technology from developed countries. This will allow a transformation from the model of "assembled in China" to "innovated in China". Such an improvement of the overall productivity is essential to keep down per unit cost for manufactures when the price levels for wage and material have been increasing. Also, technological industries do not require a large number of workers as compared to labour-intensive manufacturing. As shown previously, the working age population will reach its growth limit in the coming decades, both in percentage and absolute terms. At the same time, there are millions of university graduates entering the labour market every year, and a considerable portion of them end up not having a job. A shift to technology, service, and innovation may utilize this idle human resource, and reduce the discontent of unemployed young people. So, upgrading industries is good for almost all parties in contemporary China. If carried out successfully, it will be like an alleviator that allows the CCP to have more time and room in the process of restructuring a new SSA.

In the latest Five Year Plan, the CCP promises to boost the ability of the economy to innovate.<sup>(62)</sup> However, only a handful of developing economies have successfully developed a national innovative capacity that is comparable to the First World level in the 21<sup>st</sup> century. Moreover, none of those lucky exceptions, like South Korea, are nearly as large (geographic size, population, economy, etc.) as China. Breaking the monopoly of science and technology by a small group of developed countries is not an easy task. It requires human and capital resources, social stability, incentive policies, etc. According to the figures from the *China Science and Technology Data Book 2009*, one major characteristics of China's promotion of innovation is strong government guidance, as the state has been sponsoring key



industries with significant amounts of funding, such as information technology, energy and environment, military technology, etc.<sup>(63)</sup>

The global economic crisis caused the majority of developed countries to slash research spending. For instance, in 2008-09, major Japanese companies like including Sony and Toyota cut their R&D spending by 10-20%. In contrast, China has sustained high growth in R&D spending for several years, regardless of the boom and bust in the global economy. In terms of overall investment in R&D, China spent \$141 billion in 2010, which accounts for 12% of global R&D spending, and this amount is expected to increase to \$153 billion in 2011.<sup>(64)</sup> This number will surpass the total investment in R&D Japan by a few billion. In fact, annual increases of funds for science and technology raised by enterprises in China are bigger than those of government direct funding in the 2000s. However, despite the CCP's "Grasp the Large and Release the Small" strategy, much of the money attributed to "self-raised by enterprises" comes from government sponsorship to research institutes that have been registered as companies.<sup>(65)</sup>

A common practice of the CCP in sponsoring high-tech industries is building "innovation parks" in all major cities in China, hoping that they will function as integration platforms for capital and human resources. The biggest of them is the Zhongguancun Innovation Park (ZIP) in Beijing, where hundreds of thousands of university graduates are produced every year. ZIP is home to a lot of leading high-tech companies in China, such as Baidu, which is the country's largest internet search engine. ZIP is also famous for its attractiveness to overseas Chinese scholars and entrepreneurs. According to the estimation of James McGregor from the US Chamber of Commerce, the US alone is host to 625,000 science and engineering PhDs who were born in the PRC.<sup>(66)</sup> The government encourages those people to come to Beijing and establish high tech companies through various policies, especially those who own their own patent filed. The ZIP will

grant them 1 million RMB to start their business, and will provide them with free offices, professional consulting, and tax exemption for the first three years. Other policies include providing overseas scholars and entrepreneurs convenience of establishment registration, health care, and education for their children.<sup>(67)</sup>

According to the newly released 12<sup>th</sup> Five Year Plan, China is going to build 50 engineering centers, 32 national engineering laboratories and 56 other labs focusing on technologies like digital television and high-speed internet, 4986km of railroads, and 120000km of highways.<sup>(68)</sup> The CCP also set ambitious goals for environmental protection and conservation technologies. These include monitoring systems to gauge greenhouse gas emissions, more sewage treatment plants, and renovating conventional power plants with pollution controls. For instance, China's installed wind capacity has grown exponentially from just 10GW in 2008 to 42.3GW in 2010. Now it accounts for 22% of the world's total wind power capacity.<sup>(69)</sup>

The CCP's campaign of indigenous innovation is also highly related to its plan to expand the domestic market. In November 2009, with the release of the "Circular on Carrying out the Work on Accreditation of National Indigenous Innovation Products", the government announced that in order to be considered in the government's procurement of high-tech goods, a company would have to demonstrate that its products have indigenous innovation. Here, "indigenous innovation" is defined as products which have intellectual property rights owned by a Chinese company whose commercial trademark is initially registered within the PRC. Even if a product was developed and made in China, it would not meet these requirements if the intellectual property right was owned by a foreign company.<sup>(70)</sup> In addition, the CCP also started building other institutional conditions to facilitate innovation, such as the Intellectual Property system. These policies provoked fierce resistance, especially from the US through the WTO. In 2010, due to the complaints that "China

discriminates against foreign companies”, the Chinese government offered a limited increase of MNCs’ access to its procurement. But analysts in the US claimed that was too small a gesture to ease their concerns.<sup>(71)</sup> This is a good example of the international institutions which once facilitated China’s growth now hindering China in building the new SSA. The CCP is likely to continue to face international disputes during the process of decreasing economic dependence on foreign markets and promoting national autonomy in technology and intellectual property.

Some scholars are fairly pessimistic about the CCP’s ability to promote innovation due to the small size of funding when compared to that of the US. Also, bureaucratism is widely regarded as epidemic in Chinese research institutions.<sup>(72)</sup> However, a lot of these criticisms are based on a false assumption that the CCP is launching a full-scale competition in science and technology with the US. Articles with titles like “China is to overtake US on science in two years” are not rare in today’s mainstream media.<sup>(73)</sup> In reality, the CCP is merely concentrating on a limited numbers of areas that have the biggest potential for improving the economic productivity. In terms of overall science and technology development, countries like Japan and Germany, are not comparable to America either, though they are primarily known for high value added industries. An upgraded Chinese economy will pose much bigger challenges to these economies, rather than the US, at least not in the foreseeable future.

China’s steadily growing funding to R&D has brought signs of improvements in recent years. For instance, as reported by *The Economists*, China has experienced an astonishing boom in numbers of patent files in recent years.<sup>(74)</sup> And much of the increase comes from states policies and investment in high technology. In 2011, more patents are expected to be filed in China than in Japan, while China’s patent filings were only a quarter of that of Japan’s in 2001. This is going to be the start of a profound

reversal, as Chinese enterprises pay foreign companies more than \$10 billion in licensing and royalties annually, and that amount has been growing at 20% a year.<sup>(75)</sup>

### Conclusion: Historical Possibilities

Despite its undisturbed high speed growth after the global economic crisis, the Chinese economy today is facing a fundamental transformation as the current SSA is decaying. The CCP is taking a leading role again in building a new SSA characterized by a reliance on domestic demand and indigenous innovation. The CCP's promotion of the nation's innovative capacity has been progressing relatively smoothly in recent years, and that increase in productivity is essential for the survival and wellbeing of Chinese industries. However, innovation itself is not sufficient, because enough domestic market for Chinese goods is also necessary for future growth. The potential for expanding the domestic market is big, due to the low consumption level of China's large population. However, there are inherent limitations to the CCP's willingness and ability to implement a major income redistribution which is essential for absorbing growing productive capacity. The future of a Chinese economy that relies on the domestic market is unknown, since it largely depends on the power struggles among groups with different interests. The optimum result will only occur if the CCP overcomes the various challenges and responds to the call of workers and peasants for a more egalitarian growth model, which is essential for sustained economic development. Otherwise China will be stuck in economic stagnation and social crisis.

Last but not least, even if China successfully transforms itself into such a new SSA and continues to grow, there is the possibility that a more fundamental problem lies in the longer term. Both expanding the domestic market and promoting innovation assume perpetual economic expansion and

capital accumulation within a finite ecological capacity. All the existing energy conservation programs adopted by the Chinese government are designed to improve energy efficiency, rather than decrease or maintain the absolute energy consumption level, which is already beyond the ecological capacity.<sup>(76)</sup> As Minqi Li has illustrated, China, as well as other economic engines of the world, will face a fatal inadequacy of natural resources by the middle of the 21<sup>st</sup> century.<sup>(77)</sup> Jason Moore also proposes similar ideas that the current world ecology cannot sustain another long wave of capitalist development.<sup>(78)</sup> When drastic increases of labour, material, and energy prices squeezed out any possibility for further accumulation, the end of Chinese economic growth would come along with a crumbling of the world capitalist system.

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