



# China's Real Leadership Question

Economic Development and Social Challenges Ultimately Will Determine Who Runs the Country over the Coming Decades

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August 2012



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# Introduction and summary

Top Chinese Communist Party leaders met this month in Beidaihe, the beachside retreat on the Yellow Sea where they gather every summer to hash out critical political and economic decisions in comfort and seclusion, far from the prying eyes in Beijing.<sup>1</sup> These summer meetings are always important but this year is particularly critical. This summer they must forge a consensus to settle years of heated negotiations over who will take the helm when the current leaders retire later this fall.

The big question seemingly is who will take the remaining spots on the Politburo Standing Committee, the group of seven to nine top leaders who will guide the party and the country for the next 10 years. The top two positions are already locked in. Current People's Government Vice President and Politburo Standing Committee member Xi Jinping will become Party General Secretary and current State Council Vice Premier and Politburo Standing Committee member Li Keqiang will become the next Premier.<sup>2</sup> The remaining positions are still being hashed out and will most likely have been the focus of intense debate in Beidaihe.

These internal personnel negotiations get more contentious with every leadership transition, because each time marks 10 more years removed from the Communist Party strongman eras of Mao Zedong and Deng Xiaoping. Today there are no aging revolutionary leaders left to serve as tiebreakers when internal party factions butt heads. And this 2012 transition is the most contentious yet because none of the next generation of leaders were approved or anointed in any way by the last of those strongmen, Deng Xiaoping.<sup>3</sup> That leaves a relatively open field for the various factions to fill the top seats in the standing committee—and plenty of room for internal political infighting.

Look no further than the scandal and intrigue involving Bo Xilai, the red princeling previously considered a strong contender for one of those top leadership posts. He and his wife now stand accused of so many wrongdoings it is hard to keep them straight. His fall from grace earlier this year is still sending shockwaves through the halls of power in Beijing and across China.

For Pekingologists—those China experts around the globe who try to discern what’s going on in Zhongnanhai, the Chinese Communist Party’s small enclave near the Forbidden City in downtown Beijing—watching Bo Xilai fall and the Chinese leadership scramble to explain it all has been absolutely fascinating. This particular scandal provides a rare glimpse into the political negotiations that usually occur behind closed doors among a tiny circle of senior communist cadres who lead various political factions within the party.

But we should not get too excited about this particular incident. The Bo Xilai saga has certainly been interesting, but at the end of the day not much has changed in Beijing. The current standing committee will manage to come to a consensus on their successors and those successors will most likely continue plodding down the same economic and social policy paths that China has followed for the past 10 years under the leadership of Party Secretary Hu Jintao and Premier Wen Jiabao.

And therein lies the reason why the final composition of the next Politburo Standing Committee doesn’t really matter as much as how these new leaders will actually deal with some of the biggest challenges facing China since the initial economic reforms initiated by Deng Xiaoping in the late 1970s. In the coming decade this new leadership team must attempt to transition the Chinese economy from an export-led juggernaut to one dominated by domestic consumption and the types of investments that improve the everyday lives of the Chinese people, who, despite living under an authoritarian regime, are finding myriad ways to express their deep frustration with the direction their nation is headed.

Several decades ago, facing even more daunting challenges in the wake of Mao’s utter destruction of the Chinese economy, Deng rolled out a bold set of reforms that propelled China through its first big transition period from closed to open markets, lifting tens of millions of Chinese out of poverty and carrying the coastal provinces of the nation into the ranks of East Asia’s and Southeast Asia’s so-called tiger and dragon economies. But Deng could do this confident his authoritarian grip on China was secure and that the primacy of the Chinese Communist Party would remain unquestioned. He proved those two points in June 1989 by crushing the first open opposition to the party in Tiananmen Square and in other cities around the nation.

In contrast, the new leaders who will take the helm in late fall of this year will have to navigate a new economic and social transition from much more precarious starting points. The transition from export- and investment-led growth to domestic consumption-led growth based on technology innovation, and from lifting

tens of millions out of abject poverty to satisfying a more demanding middle class will be even harder for the party to execute. The reason: It will require the kind of deft governing skills that authoritarian regimes are generally not good at using. To further complicate matters, based on their performances thus far, it appears there is not a single bold leader in this new group who can push the necessarily ambitious economic and social reforms while also preserving the Chinese Communist Party's absolute grip on power.

The new standing committee will include an interesting group of cadres, but none of them appears to be another Deng Xiaoping—a visionary reformer and steely-eyed dictator who could enact sweeping change while maintaining the communist party's absolute grip on power.

That means this new crop of Chinese Communist Party leaders may not be able to repeat Deng's successes amid what promises to be a very rocky next 10 years in China. And as interesting as 2012 has been for Pekingologists, China's current leaders and their incoming replacements are already dealing with something far more important: figuring how to adapt China's political, social, and economic systems to power through the next development phase and avoid falling into economic stagnation and political turmoil. To do so, they must answer two questions correctly:

- What combination of economic growth and social improvements will they have to deliver to maintain popular support over the next 10 years?
- What changes will the Chinese Communist Party have to make in order to meet those goals, and how can they do so while also maintaining their grip on power?

The answers to these questions will ultimately decide how long the Chinese Communist Party can stay in power and whether China's rise can continue over the coming decades. This report takes these two questions as its core mission, attempting to provide a framework for considering them rather than trying definitively to answer them, which of course would be impossible. It is difficult to predict exactly how China's new leaders will behave once they take over this fall. But framing the problems facing China is a perfectly fine way to define the challenges the new leadership must tackle, which in turn informs how the Chinese leadership may react to these problems for the good or ill of the party and the Chinese people.

This report explores these two questions first through the prism of the ongoing Bo Xilai case to explain why the corruption scandals and political intrigues currently making headlines do not pose new or insurmountable problems for the party. The

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report then explores the two challenges that could potentially be insurmountable: overcoming the vested interests resisting central government attempts to rebalance the economy and improving quality of life for China's growing middle class without sacrificing single-party rule.

In the pages that follow, this report will detail those anticipated challenges and how China's new leaders may deal with them. But, briefly, here is a synopsis of the analysis:

*The Bo Xilai scandal has led many to question how much longer the Chinese Communist Party can maintain its grip on power, but corruption scandals and factional infighting are old problems with familiar solutions. The real threats facing the party today are the new problems that do not yet have clear solutions, two of the biggest being economic rebalancing and figuring out how to satisfy China's growing middle class.*

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## Rebalancing the economy will require political capital that this group may not have

For the past three decades, the Chinese Communist Party has maintained its grip on power by promising to keep the economy growing and to keep improving living standards. The first stage of growth (from lower to middle income) was enormously successful. The next stage (from middle to upper income) will be harder to traverse, and that makes it harder for the party to keep delivering on their promises to the Chinese people.

The only way Beijing can keep the economy growing and avoid falling into the so-called middle-income trap—falling into a period of economic stagnation, as happened in Malaysia, the Philippines, and Thailand—is to shift from export- and investment-led growth (which is producing diminishing returns) toward a new growth model based on domestic consumption and technology innovation. To do that, Beijing must reduce government support for state-owned enterprises and traditional industries such as coal and steel and increase the support given to private enterprises and the industries of the future such as clean energy and next-generation information technology.

Beijing must also stop channeling credit through state banks and local government officials, who make investment decisions based on cronyism. Instead, Chinese leaders need to rely more on commercial banks, which have incentives to lend

to the best companies and technologies regardless of their political connections. Expanding the profit incentives and reducing the political incentives driving credit allocation is the only way that Beijing can ensure that the technologies China produces will actually be competitive on the global market.

The problem is, all those reforms require Beijing to transfer money and policy support from the politically powerful—local government officials, state-owned enterprises, and traditional industries—to the politically weak, private enterprises and infant industries. That is hard to do in any country. It may get even harder to do in China once the new leadership takes the stage this fall because this new group appears to be more divided and politically weaker than its predecessors.

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Beijing faces massive challenges meeting its economic promises to the Chinese people, and China's growing middle class is demanding even more

For many Chinese people, the first stage of economic growth provided bigger homes, better access to new consumer goods, and the freedom from worrying about having enough to eat. Now they want more—particularly China's growing middle class. They want quality-of-life improvements such as a cleaner environment, higher food-safety standards, and protection from local government abuse, but those things could be hard for the Chinese Communist Party to deliver.

The United States can deliver those things because we have a strong democracy, independent courts, and a free press. In China, local governments are their own little kingdoms. They control the courts and the press, and they don't have to worry about elections. As a result they are often more interested in making money than improving the quality of life for local citizens—and there is not much those citizens can do about it. Local officials expropriate their citizens' land and homes without paying for them and then let developers move in to build factories that pollute the environment.

In previous decades, many people felt that the opportunity to work in those factories made the other problems worthwhile. That balancing is now shifting. Many Chinese people are no longer willing to put up with problems such as excessive environmental pollution, and they are flooding the streets in mass protests that give Beijing nightmares.

It will be extremely difficult for Beijing to address environmental pollution and other quality-of-life problems without becoming open to major political reform, and they do not want to do that quite yet. Until then, the best they can do is to make small improvements and hope that will be enough to prevent major social unrest. Whether that works will depend largely on whether Beijing can keep the economy growing. As long as the economy is booming, most Chinese citizens can put up with at least some political frustrations. If growth slows too much, however, Chinese Communist Party rule will begin to look like a bad deal on multiple fronts.

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The United States will have to learn to deal with a China that is increasingly divided and uncertain about its future

For the United States, China's neighbors in Asia, and the world at large, how China's new leaders carry their country through perhaps wrenching social and economic changes in the coming years will help determine their own economic growth prospects.

Whether the Chinese leaders succeed or fail will also impact how China deals with the world around it and whether China will play a positive or negative role in global peace and cooperation. Understanding how this all plays out in China could not be more important for policymakers around the globe. We attempt to set the stage in this report.

# Understanding China's leadership dynamics

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## Corruption scandals and cadre ousters not uncommon in Chinese Communist Party politics

Without a doubt, the ongoing Bo Xilai scandal definitely has some unique elements to it. In terms of sheer tabloid drama, this particular case really has no comparison in modern Chinese history. Previous high-ranking members of the party have been murdered, purged, or isolated indefinitely under house arrest amid previous political transitions, but the difference in Bo's case is in the way the case is unfolding, the characters involved, and the new media environment in which it is all being reported—an environment where scandalous details are hard to keep quiet.

In short, the current and future party leadership is engaged in the purge of one of its own while for the first time having to answer to an aware Chinese public about the reasons why it's happening. But it is important to remember that the Bo scandal is certainly not the first major corruption scandal to rock the Chinese Communist Party since Deng led the nation into the modern economic era. It is virtually impossible now to climb the party ranks and stay completely clean because China's authoritarian political system encourages corruption at every level.<sup>4</sup> That means corruption scandals are inevitable, and the party knows how to deal with them.

When scandals emerge, party leaders have two key priorities: keep the party together and keep most Chinese citizens convinced that the current system is still working fairly well and still a better bet than pushing for democracy and risking political turmoil. Toward that end, party leaders go to great lengths today to convince Chinese citizens that corruption scandals are isolated incidents caused by a few bad eggs rather than a systemic problem with single-party rule. Corruption scandal response, therefore, is all about damage control, and the party's handling of these cases follows a predictable pattern.

Their first step is to determine who will take the fall. Those cadres caught up in a scandal will be framed as those few bad eggs, wholly responsible for the problem.

Party leaders will pin all of the blame on them and take action against those cadres to appease the public. In 2007, for example, Party leaders responded to a series of food and drug safety scandals by ousting and executing the head of the State Food and Drug Administration, Zheng Xiaoyu.<sup>5</sup> Indeed, harsh remedies, including capital punishment, are not uncommon when the party needs to make an example of one of its own.<sup>6</sup>

Corruption cleanups are always designed to take out just enough key people to remove internal threats and assuage the public. If they go too far by exposing and removing too many cadres (and thus publicly airing too much dirty laundry), then that could send a message to the party's rank and file that their leaders are not looking out for them. And it could send a message to the Chinese public that the entire system is problematic.<sup>7</sup>

Once party leaders decide which cadres to axe (either literally or figuratively), they use the state-run media as a propaganda machine to pin everything on those cadres and present the case to the public as a done deal. Media control is critical for cauterizing these scandals to keep the political damage from spreading. Once top leaders decide how the scandal will be presented and how it ends, all media outlets must present that version of the facts.<sup>8</sup> Any media attempts to independently investigate corruption scandals and present an alternate version of the facts are severely punished.<sup>9</sup> Most journalists and editors know better than to even try.<sup>10</sup>

These official media announcements also demonstrate to the public that party leadership has reached an internal consensus on how to handle a particular case. What is currently very interesting in the Bo Xilai case is that we have not yet heard much from the leadership or the state press. That suggests top leaders have not yet managed to come to consensus on exactly who will be taken out (other than Bo himself) and what the various punishments will be.<sup>11</sup>

Party leaders are running out of time to make these announcements. They absolutely must do so before the 18th Party Congress commences this fall. If not, that will signal to the Chinese people that the leadership is seriously fractured and encourage China's social discontents to voice their complaints more boldly, most likely via sustained mass protests. That is something the party must avoid at all costs.<sup>12</sup>

From a strictly administrative standpoint, the Bo Xilai case has a precedent. Bo Xilai was a Politburo member and a provincial-level party secretary but so was former Shanghai Party Secretary Chen Liangyu when the national Party Secretary

Hu Jintao purged him in 2006.<sup>13</sup> What complicates things with Bo is the fact that he has a revolutionary pedigree. He's the son of Bo Yibo, a Mao-era revolutionary leader who survived the Cultural Revolution to become one of the "Eight Immortals," the eight powerful officials in Deng Xiaoping's inner circle.<sup>14</sup> Bo Xilai was also expected to ascend to the Politburo Standing Committee this fall, and that puts him very close to China's top echelon. If the party paints him in too dirty of a light then it may be hard for the leadership as a whole to remain clean in the eyes of the Chinese public.

Bo Xilai was also a media darling—a new phenomenon in China—and his "give everyone a slice of the cake" rhetoric was a big hit among Chinese peasants and poor city dwellers who feel they have been left out of China's postreform economic success.<sup>15</sup> That makes it even trickier to tar and feather him in the Chinese state press because any strikes against Bo could easily make his opponents look like antipopulist elitists. In modern authoritarian China, this actually now matters.<sup>16</sup>

From that perspective, the murder allegations against Bo Xilai's wife were a political godsend for Current Party Secretary Hu Jintao and his allies. Bo had always been like the cat with nine lives—tenacious, connected, and extremely hard to get rid of. In 2007 Hu Jintao demoted Bo from commerce secretary—a high-profile national leadership position—to the party secretary of Chongqing, a backwater municipality in Western China. Instead of viewing the Chongqing post as a path to retirement, however, Bo Xilai turned it into a national political platform. He rolled out people-oriented development policies, launched a "smashing black" campaign to take out organized crime rings, and encouraged local citizens to dress up in red outfits and sing "red songs" that harkened back to a more egalitarian era.<sup>17</sup>

China's urban and rural poor were captivated by the images of Chongqing citizens singing en masse and apparently being lifted into a better life by Bo Xilai. But many wealthy elites and liberals were horrified by Bo's glorification of the Mao era. Hu Jintao and his allies were equally horrified. Hu repeatedly snubbed Bo by refusing to take an inspection tour to Chongqing and refusing to show up for a red songs competition Bo staged in Beijing. But Bo Xilai had other friends in the central leadership, and those leaders saw his growing popularity among the disenfranchised as a major political asset.<sup>18</sup> (See "Understanding China's political factions" on the following page of this report.)

Everything came crashing down when internal investigations (reportedly launched by Bo Xilai's enemies in Beijing) unearthed a murder and sent his police

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chief running to the U.S. consulate with a handful of scandalous documents last February.<sup>19</sup> That gave the Hu Jintao camp enough political maneuvering room to turn Bo Xilai's red song campaigns against him and paint him as a crazed leftist who was trying to drag the country back to the Cultural Revolution era and wipe out decades of reform.<sup>20</sup> Party leaders removed Bo from his official positions, but they did not announce what they will actually charge him with or what further punishments he will receive. That part is trickier because that impacts not only Bo Xilai himself but also a whole host of his allies, many of whom, like former Party Secretary Jiang Zemin, are extremely influential.

Some analysts believe that the recent launch of judicial proceedings against Bo Xilai's wife Gu Kailai signal that an agreement has also been reached on how to handle the corruption allegations against her husband.<sup>21</sup> The Chinese state press claims that when her trial commenced this past week, Gu Kailai confessed to the murder charges, accepted responsibility for inflicting harm on the Chinese Communist Party, and promised to "accept and calmly face any sentence."<sup>22</sup> Those statements certainly suggest she is keeping up her side of a bargain, but that bargain may only include protection for her son—not leniency for her husband. Only time will tell how the rest of this case shakes out.

## Understanding China's political factions

It is difficult to know for sure how internal negotiations will play out behind closed doors in Beijing and at the Chinese Communist Party's decision-making retreat going on this month at Beidaihe, on China's northeast coastline. Based on what we do know, however, the party appears to be split into two major internal factions.

Current Party General Secretary Hu Jintao and current Premier Wen Jiabao head one faction of cadres. That group is generally called the "populists," or tuanpai, so named because they mostly hail from Communist Youth League faction of the party.<sup>23</sup> Most of these cadres do not come from elite family backgrounds. Instead, they climbed up the party ranks from relatively modest beginnings. Many held positions in the less-developed regions of central or western China, and many served under Hu Jintao in the Com-

munist Youth League, where he spent much of his career. Likely future Premier and Hu Jintao protégé Li Keqiang is also considered a populist, as are likely future standing committee members Li Yuanchao and Wang Yang.

Previous Party General Secretary Jiang Zemin and current Politburo Standing Committee members Wu Bangguo and Jia Qinglin head the other faction. That group includes many sons and daughters of senior cadres under the late strongman Mao Zedong, which is why they are referred to as China's Communist Party "princelings." That group also includes members of the "Shanghai gang," who served under Jiang Zemin in that coastal city.<sup>24</sup>

*Continued on next page*

Most party cadres amass wealth by the time they reach the top echelon, but the princeling camp generally has even more opportunities to do so—due to elite family connections, careers in China's more prosperous eastern cities, or both.<sup>25</sup> Zhu Rongji, who served as premier under Jiang Zemin, is considered a member of this faction. Likely future Party General Secretary Xi Jinping, likely future Politburo Standing Committee member Wang Qishan, and scandal-ridden Bo Xilai are also princelings.

On a policy front, Hu Jintao's populists are generally seen as more liberal than Jiang Zemin's elitists. In China's political context this broadly means that the populists are more willing than the elites to consider

some extremely tentative steps toward more political participation for the Chinese people. But this broad definition is by no means clear cut.

Indeed, it is not clear to what degree populist versus princeling factional ties actually influence the cadres' policy positions. But where factional ties are most important is in personnel appointments.<sup>26</sup> Outgoing and retired leaders such as Hu Jintao and previously Jiang Zemin compete with one another to get as many of their key protégés as possible in top leadership positions because that strongly influences their own political power over the next generation. Going forward, though, China's factions will have to tackle serious policy problems by taking stands for or against more economic reforms.

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### At the end of the day, party elites know they must stick together

This case is no doubt triggering a huge amount of internal debate. At the end of the day, however, China's top party leaders know that they must either stand together or they will all fall together. Elite splits, if they become public, would almost certainly lead to a decline of party power and a loosening in social control—which could send people out into the streets in mass protests, just as the last elite split did in 1989.<sup>27</sup> The lessons of Tiananmen provide a strong incentive for all factions within the party to make whatever concessions they have to make for the group to reach consensus.<sup>28</sup>

But are current internal debates serious enough to block consensus and leave the party stuck in limbo? Will the top leadership simply fail to resolve these politburo personnel issues or to figure out how to deal with the Bo Xilai scandal before the 18th Party Congress? That would signal to the Chinese public and to the lower party and government administrative ranks that the top leadership is divided and therefore weak. Protesters would see the failure as a signal that now is the perfect time to take to the streets in mass protests to push for change on contentious political issues such as environmental pollution and rural land expropriation. Lower-level officials would see that as a signal that now is the time to push back on policies they do not like. That would make governance even harder for the next round of party leaders and further reduce popular support for single-party rule.

Signaling a lack of consensus at the top also would spark absolute panic through Chinese financial markets and further destabilize the economy. A healthy contingent of China's wealthy elite was already panicking over the possibility that Bo Xilai would ascend to the Politburo Standing Committee and push for a return to anti-market socialism, however improbable. His ouster assuaged those fears somewhat, but it also painted Beijing in a politically unstable light. Chinese elites reacted to that instability by moving even more capital abroad and frantically applying for foreign immigration visas at even higher rates than before.<sup>29</sup> If it begins to look like the party is cracking up, these fears will only escalate and Chinese markets will suffer.

So if not political limbo, then could contentious internal debates lead a political faction within the party to split off and actually try to stand alone as an alternative to the Chinese Communist Party? For that to succeed, that faction would need to somehow control the media (to get the public on its side) and the military, yet the party currently has the media and the military so locked down that sustained insurrection from either side is currently inconceivable.<sup>30</sup>

The party is still strong enough to deal harshly with any cadres who break discipline. Anyone considering such a move need not look any farther than Bo Xilai himself. His red song campaign and brazen play for a central leadership position broke one of the party's most important rules: Always present a united front and keep personal career ambitions and internal divisions out of the public eye. Once he broke that rule, Bo gave his critics within the party major ammunition to go after him, and that launched the internal investigations that led to his downfall.<sup>31</sup>

Overall, at this point, the forces holding the party together are still much stronger than the forces pulling it apart. If things become extremely fractious at the top—if Beijing is wracked by another epic corruption scandal, for example, or if the economy tanks and current leaders are unable to turn things around—then that might create new openings for elite splits of the Tiananmen variety. At the moment, however, China has not reached anywhere near that kind of crisis point. Until it does, it will still be in everyone's best interest within the upper echelons of the party to reach a consensus and stand together.

It is most likely, therefore, that China's current leaders will come to consensus this summer on who the next Politburo Standing Committee will be and announce that to the world in the fall. Party politics will go on as usual. The real question, then, is what this new group of Chinese leaders will actually do once they step up to the podium? These new leaders will face two massive challenges:

- Rebalancing the Chinese economy to power through the next stage of development
- Satisfying the demands of China's rising middle class to reduce growing social pressures for more serious political reform

It is not yet clear how well this group will achieve either of those objectives. To this we now turn.

# Rebalancing the economy to meet the demands of China's rising middle class

For the past three decades, Chinese economic growth has depended primarily on exports and state-funded fixed asset investments in infrastructure and real estate. That model is now running out of steam. Domestic wages are rising, which is eroding China's cost advantages as a low-value-added manufacturer. Fixed-asset investments are consuming too much energy, polluting the environment (which triggers destabilizing mass protests), and concentrating wealth among the leaders of state-owned enterprises and their buddies in the local government who dole out these big infrastructure contracts, sometimes in exchange for lucrative kickbacks.

To keep the country growing and to keep their citizens happy enough to support the regime instead of protesting against it, Chinese leaders must shift the country toward a new growth model that will depend less on exports and fixed asset investments and more on domestic consumption and higher-end technology innovation. Consumption and innovation are connected and both benefit China's growing middle class.

If Chinese companies can move up the value chain from lower-end to higher-end manufacturing, they can pay their employees more, which will expand job and wage opportunities for average Chinese citizens. Once Chinese citizens have better jobs and higher wages they can then buy more, allowing Chinese companies to sell more of their goods domestically instead of depending primarily on export markets, which can be unpredictable. Higher wages for Chinese workers would also address one of the biggest complaints about the current system—that wealth is too concentrated in the hands of a well-connected few at the expense of ordinary Chinese.

Technological innovation is particularly important in this quest. Thus far China has primarily served as a manufacturer for western designs. If they can shift not only toward higher-end goods but also from western to indigenous Chinese designs, then Chinese firms will get a larger share of those profits. Today Western firms hold the intellectual property rights for most of the higher-technology goods

China produces. That means Western firms get a large cut of the profits for every unit sold. If China can keep more of those profits at home, that would provide new revenue streams for the Chinese economy.

Unfortunately, those goals will be very difficult to achieve for two reasons.

First, moving toward a modern, higher-tech, consumer-driven economy will require the type of independent regulatory governance and judicial structure that it is very hard for an authoritarian regime to provide. One of the biggest stumbling blocks is providing a good domestic environment for technology innovation. Investments in innovation will not deliver good returns without a good legal system to protect intellectual property rights. The United States has such a system, which is why U.S. technology entrepreneurs and venture capitalists are willing to risk so much on new ideas.

In China, however, the Chinese Communist Party worries independent courts would turn against it, so the party keeps the courts on a short leash. There is no judicial independence in China. If party cadres do not like the way a judge rules in a case, they can have that judge fired. That gives party leaders sway over every court decision and opens up the possibility that they will use that sway to protect favored companies. And that means investors cannot trust Chinese courts to enforce intellectual property rights laws in a fair and impartial manner.

That was all fine and good as long as most intellectual property cases were being filed by foreign companies against Chinese defendants. In that situation, weak IP enforcement was just another form of protectionism. The American Semiconductor case is a recent example of that traditional dynamic. American Semiconductor Corp., or AMSC, has clear evidence that Sinovel, the Chinese wind turbine manufacturer, stole AMSC engineering secrets and used them to produce a Chinese product based on AMSC designs.<sup>32</sup> American Semiconductor responded by filing suit against Sinovel in the Chinese court system. In the West AMSC's suit would be an open-and-shut case, but Sinovel has strong party and government backers, so Chinese judges keep throwing the case out of court.<sup>33</sup>

Chinese leaders may not mind giving foreigners a hard time, but now they want Chinese companies to come up with their own engineering secrets. If ownership rights are hard to enforce, however, few Chinese companies will have an incentive to do so. That is particularly the case for private-sector companies who would have

to invest their own funds or take out large loans to develop new technologies. And those are exactly the types of companies China needs to encourage if it wants to move up the technology value chain.

This past May current Party Secretary Hu Jintao convened a Politburo meeting to address this problem. At that meeting party leaders talked about the need to build a more supportive environment for innovation and announced a new goal: making China one of the world's most innovative countries by 2020.<sup>34</sup> Chinese scholars interviewed for this report in Beijing claim Hu Jintao is planning a big innovation policy push for this fall that will focus not on channeling more R&D funds toward state-owned enterprises (which has not worked that well so far), but rather on the systemic barriers to a more competitive innovation environment, including intellectual property enforcement.

No matter what the party comes up with, however, we can bet that it will not include judicial independence. As long as the party insists on maintaining control over the courts, China's intellectual property regime will favor whoever has the best political connections, not the best innovators, and that will deter some of China's best and brightest technology prospects from taking a gamble on new ideas.

Shifting the economy toward a new growth model will also require reducing government support for the state sector, and that is not easy to do. For the past 10 years the Beijing leadership directed by Party Secretary Hu Jintao and Premier Wen Jiabao has had to focus more on social stability and less on economic reform. When economic problems emerged they threw money at those problems instead of making difficult political adjustments. This culminated in China's 2008 stimulus package, which doled out RMB 4 trillion (\$586 billion) over two years to keep the economy running throughout the global financial crisis.<sup>35</sup>

More than 80 percent (\$468 billion) of those stimulus funds were earmarked specifically for infrastructure and construction projects.<sup>36</sup> Beijing issued treasury bonds to finance some projects and ordered state banks to support the rest by providing long-term, low-interest loans to the companies involved.<sup>37</sup> Local government cadres were thrilled because they got to decide which projects to build and which companies to award the contracts to. Overall, the stimulus program put China's local government officials in charge of huge amounts of pork, and pork can buy a lot of friends in China. Most of the stimulus projects were contracted out to state-owned enterprises with connections to China's local governments and

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state banks.<sup>38</sup> All across China, elite groups of government officials, bankers, and well-connected state-owned enterprises were passing around huge amounts of money, and they could not have been happier.

Now Chinese leaders need to redirect that spending from local governments and state-owned enterprises to private-sector innovation by allowing banks to choose projects based on profitability rather than political connections. China must shift from letting its government officials pick winning companies based on those same connections to letting the market pick the winners based on who has the best technology. That is the only way China can climb up the value chain to become a major global innovator. It will not be easy, however. Local officials and the heads of local state-owned enterprises (often one and the same) strongly resist any reforms that redistribute wealth at their expense, and those are very powerful interest groups in China.<sup>39</sup>

In China's political system, the leaders in Beijing—who today can claim neither democratic legitimacy nor Mao-era ideological legitimacy—need support from the lower levels to make big policy decisions. The Politburo (the top 25 party leaders) and the larger Chinese Communist Party Central Committee include not only national leaders based in Beijing but also powerful provincial officials. Just like congressional representatives here in the United States, China's provincial officials bring their own interests to the table when they participate in economic decision making in Beijing. And key policy decisions are always made via consensus, so Beijing has to take those regional interests into account. Top national party leaders such as Hu Jintao today and Xi Jinping in the future cannot ram reform plans down the throats of their subordinates—they have to get their support.

During the first era of economic reforms, Deng Xiaoping bought that support by giving local government cadres more authority over the local economy.<sup>40</sup> The next era of reforms will require taking some of that economic authority away. For economic rebalancing to succeed, local cadres can no longer be in charge of picking winning firms and awarding lucrative contracts for massive infrastructure projects. Instead, commercial banks will allocate capital to the projects and technologies that show the most promise, regardless of which region they are located in or who their friends are.

This would be good for China in the long term, but not so good for local government officials and state-owned enterprises in the short term, particularly if they have sunk investments into less-competitive industries and technologies that

would be phased out under a more market-based system. Those officials and state-owned enterprises will fight hard to keep that from happening.

Chinese leaders have plenty of cash, so they can easily funnel resources into new industries. They are already directing funding toward strategic emerging industries such as green technology products and next-generation information technology equipment and software. Where they run into trouble, however, is in actually getting those new industries off the ground. That requires turning off the spigots of government support flowing toward the older and more inefficient industries and state-owned enterprises, a tough task when local government officials are fighting hard to keep them alive.

In green energy, for example, Chinese leaders have directed substantial resources toward wind and solar. That has paid off in clean energy manufacturing: Chinese companies are using cost innovations to manufacture cheaper versions of wind and solar technologies developed abroad, and they are exporting those products all over the world. What Chinese leaders really want, however, is to develop their own technologies and sell more of them at home, and that is not going so well. Chinese leaders are doling out funds for clean energy R&D, but they distribute them through government channels, and government officials direct the money toward old friends instead of new prospects. Resources go to the well-connected instead of to the entrepreneurial. Many private enterprises cannot get financing, and private enterprises are more likely to generate the new ideas China needs.

China's ability to buy and install those clean energy products at home is also lagging behind, particularly in the solar industry. Chinese solar panel manufacturers export more than 90 percent of the products they produce, and those exports are currently being hit with tariffs.<sup>41</sup> Chinese solar manufacturers want Beijing to increase domestic solar energy consumption so they can sell more solar panels at home and depend less on exports (thus limiting their exposure to tariffs), but the growth of solar demand in China is much slower than it could be.<sup>42</sup>

That's because China's electricity sector is dominated by state-owned enterprises that prefer to stick with the coal infrastructure they already have instead of investing in new technologies such as solar. Solar generation is still more expensive than coal, and China's generation companies can't make a profit even using coal because Beijing fixes electricity prices at below-market rates to keep consumers happy.

Over the past few years, coal prices have gone up, but electricity prices stayed low, so China's state-owned power generators have been selling electricity at a loss and getting government bailouts to balance the books.<sup>43</sup> The last thing those companies want is to increase their costs and losses even further—and Beijing cannot increase electricity prices too much because that would slow down the economy and infuriate consumers.

China has a “Golden Sun” program that provides government money to build solar generation plants, which should help bring down costs, but local governments are not managing it well, and many Golden Sun projects have been plagued with fraud.<sup>44</sup> For the solar generation projects that have been built, getting connected to the grid is also problematic because China's State Grid Corporation (a state-owned enterprise) controls 88 percent of the country, and State Grid is dragging its feet on renewable energy connection.

All of these factors keep China tied to coal and lock China's clean energy economy into the old model of depending primarily on exports instead of selling more goods at home. Overall, then, China is locked into a situation where the central government is trying to push their economy in new directions, but central-local political dynamics constrain Beijing's ability to transform the system in a meaningful way.

To be sure, the country has made some progress. When measured by annual growth rates, China's domestic clean energy markets are booming, and no one doubts Beijing's determination to turn its country into a clean energy powerhouse. The problem is that things are just not moving quickly enough, particularly on domestic consumption and home-grown technology innovation—and those are the clean energy improvements that China really needs.

Overall, it seems as though every time Beijing comes up with a new idea, vested interests stand in the way. If China's incoming party leaders cannot find new solutions to these problems, then economic growth may slow dramatically. And that has major implications, not only for the economy, but also for the Chinese political system more broadly.

# Satisfying China's rising middle class in an era of economic uncertainty

For the past three decades, the Chinese Communist Party has maintained power by offering its citizens a bargain they could not resist: The citizens support the communist party's authoritarian grip on power, and in return the party keeps the economy growing and uses the cash to give everyone a better life. As China moves into the next development phase, it's going to be harder for the party to keep up their end of that bargain. And to further complicate matters, instead of accepting less, the Chinese people are going to be demanding even more.

Now that the Chinese people have become more prosperous, economic growth is no longer enough. Everyday Chinese want more, especially the country's rising middle class. They already have decent homes, cars, and plenty to eat. Now they want a more transparent government, cleaner air and water, safer food and drug supplies, and a judicial system that actually works. Basically, they want a lifestyle that looks a lot like what we have here in the United States.

Problem is, the United States is a democracy, and China is not. Beijing answers to no one, and local governments are their own corrupt little kingdoms. The leaders in Beijing know they have to fix problems such as environmental pollution and poisonous food products to keep people from protesting. Local governments are generally more interested in making money, however, and not so interested in enforcing regulations to improve quality of life.<sup>45</sup>

Beijing can order them to do so, but China is a big country, and Beijing is usually far away. Local businesses are much closer and they have a lot of cash. When local officials have to choose between following Beijing's orders versus protecting business in exchange for kickbacks, the latter often looks like a much better deal. That creates major corruption problems.

Infrastructure development projects, in particular, are hotbeds of corruption. Businesses can site those projects anywhere in China, so regional governments compete with one another to attract investors and win the tax revenues and kick-

backs those deals can bring. That often involves ignoring laws protecting citizen rights. Local officials kick people out of their homes with little or no compensation, lease the land to a developer at extremely low rates, and then allow that developer to violate a whole host of environmental standards. Businesses save millions in construction costs, but citizens suffer, first by losing their land and homes, then by exposure to dangerous pollution.

This creates major problems for Beijing, not only because it makes the government look bad but also because Beijing has to worry that angry citizens will express their frustrations in mass protests. And worry they should. It is difficult to say for sure exactly how many protests erupt in China every year. Statistics vary depending on how different government agencies define the term “mass incidents,” but over the past few years the central government’s annual protest statistics have ranged between 50,000 and 100,000 per year.<sup>46</sup> This is despite the fact that the Chinese central government budget for “public security” (preventing and stopping mass protests) has eclipsed the country’s national defense budget for two years running. The 2012 budget allocated over RMB 700 billion (\$110 billion) to domestic police and paramilitary forces, \$5 billion more than Chinese leaders gave the People’s Liberation Army for national defense.<sup>47</sup>

Here are just two examples of what the Chinese communist leadership faces. This July in Qidong, a coastal city near Shanghai, thousands of residents took to the streets to protest a waste discharge pipeline that would have decimated fisheries and polluted drinking water.<sup>48</sup> Enraged protesters did more than just march through the streets. They also attacked city government buildings and overturned cars. That same month in Shifang City, Sichuan Province, thousands of citizens surrounded and attacked government buildings to protest a copper factory.<sup>49</sup>

These protests are sprouting all over China and presenting Beijing with a major red line. If Chinese leaders cannot address the corruption problems and quality of life issues, the protests will likely get bigger and more frequent until they grow into something the party cannot shut down. Chinese leaders need look no farther than Hosni Mubarak’s regime in Egypt to see what that would entail.

One way Chinese leaders are trying to solve these problems is by borrowing strategies from western democracies, without going so far as to actually democratize. Chinese leaders are trying to improve the functioning of their courts, for example, so that their citizens can sue local officials when those officials ignore Beijing’s laws (by kicking people off of their land without providing adequate compensation).<sup>50</sup> Beijing

is also giving Chinese journalists and nongovernmental organizations a bit more leeway to expose problems like environmental pollution and food safety incidents.

Problem is, they never go quite far enough. The courts are still not independent, so cronyism derails most cases.<sup>51</sup> Journalists and social organizations are still kept on a tight leash. Local governments can still have journalists or activists fired if their investigations get too political and that cuts many watchdogs off at the knees. Overall, Beijing flirts with elements of a democratic society, but never goes far enough to enact real change. The end result is that they are not fully addressing their citizens' growing complaints, raising the question of whether Chinese leaders will be able to keep things going in a more economically developed era.

Some foreign observers saw China's reaction to the Wukan protests (in Guangdong Province) last fall as a sign of progress. Party leaders in Wukan had to decide how to reassert control after local officials and police clashed with angry residents over corruption problems and then retreated, ceding Wukan Village to protesters.<sup>52</sup> Instead of sending in tanks as Deng Xiaoping did to clear Tiananmen Square in 1989, Guangdong party leaders sent in representatives to hear the people's complaints, and they even allowed the villagers to hold a special election to appoint one a protest leader as the new village party chief.<sup>53</sup>

This was a fascinating and positive development, but Wukan's experience is not likely to be repeated nationwide. Wukan is located near Guangzhou and Hong Kong, two major international cities, so the Wukan crisis attracted international media attention, making the party's response as much about public relations as it was about maintaining social stability. With most Chinese protests, local officials are more likely to respond with crackdowns than elections.

At a fundamental level, Chinese leaders understand that there is only one way forward. They have to give their growing middle class more of what they want, and what they want is looking more and more like the kinds of government goods, services, and accountability that Western democracies deliver. Marginal reforms and small political concessions will not achieve that, though they will buy time, which alone is a big accomplishment. The question is how much time they have left.

That will be largely determined by how well China fares on an economic front. As long as the economy is booming, most Chinese people can put up with some political frustrations, because as long as the political frustrations don't get too bad, they still seem like a worthwhile price to pay for economic growth. If the economy slows down too much, however, that bargain no longer looks like a good deal.

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# Will the next generation have what it takes?

The question we should all be asking is whether China's new leaders can meet these challenges. They are a diverse group, but none of them appear to be big thinkers. And none of them appear to have the political clout they would need to push big, new ideas past conservative internal opponents.

Xi Jinping, the presumptive next party secretary, appears very similar to current Party Secretary Hu Jintao. Like Hu, Xi's biggest redeeming quality is that he has managed to rise up the party hierarchy without creating major waves, getting caught up in any major scandals, or creating too many enemies. Like Hu, that makes Xi a good consensus candidate for party secretary, because although he is probably not anyone's first choice, he is at least acceptable to a wide range of cadres.<sup>54</sup>

Li Keqiang, the presumptive premier, was most likely Hu Jintao's counterbalance against Xi Jinping, because Xi is a princeling, and Li Keqiang is loyal to Hu Jintao's populists. Their predecessors were already factional allies when they assumed those positions (populists Hu Jintao and Wen Jiabao and elitists Jiang Zemin and Zhu Rongji), but, as best we can tell, Xi Jinping and Li Keqiang are not. It is not yet clear whether their different factional ties will make it easier or harder for Xi and Li to get things done in Beijing. (See sidebar on page 10 for a brief explanation of the factions within the Chinese Communist Party.)

The rest of the likely appointees are a bit more interesting. Current organization department head Li Yuanchao, a Hu Jintao protégé, will almost certainly be promoted to the Politburo Standing Committee, and he will be interesting to watch on the reform front. The organization department is responsible for designing and operating China's vast personnel system—it sets the guidelines for how party cadres are evaluated and which aspects of their performance weigh more heavily in determining who moves up the ranks.

As head of that department, Li Yuanchao led the effort to make public opinion polls an important element in personnel evaluations.<sup>55</sup> Previously, those evalua-

tions were based only on internal assessments and the public had no voice in the process. Now the party conducts opinion polls across the country to find out how local people rate their local leaders, and they include those results in cadre evaluations. It may not be the U.S. ballot box, but those polls do give cadres an extra incentive to keep people satisfied.

Li claims that many cadres strongly opposed that move but that Hu Jintao gave him the political support he needed to overcome their opposition.<sup>56</sup> That suggests Li at least has at least some experience pushing new ideas past internal resistance. None of his programs thus far have been anything near major political reform, however, and it is not clear whether he would offer anything bolder as a member of the Politburo Standing Committee.

It is also not clear what he can do without the party secretary backing those efforts. Xi Jinping, the next party secretary, will be from an opposing faction, and that may constrain Li's maneuvering room. As one of the few candidates who have actively promoted at least some political reforms, however, he is certainly worth watching. If economic stagnation throws Beijing into crisis mode and the standing committee needs to put someone in charge of rolling out more ambitious political reforms to appease an angry public, Li would be a natural choice.

Wang Qishan, the current vice premier for economic, energy, and financial affairs is considered a strong economic manager, and he has good relationships with the business community in China and in the West. But it is not clear what role he will play in the new standing committee and how he will get along with presumptive Premier Li Keqiang. The reason: It is well-known that many of China's princelings in Jiang Zemin's faction lobbied long and hard to give the premiership to Wang Qishan instead of Li Keqiang.<sup>57</sup> That effort was not successful, but it is not something Li Keqiang is likely to forget.

As the head of China's government, Li may try to sideline Wang Qishan to avoid being overshadowed on economic affairs. It will be interesting to see how Xi Jinping, Li Keqiang, and Wang Qishan interact once they take their places at the top. Although Li Keqiang will take the premiership and therefore should serve as Xi Jinping's number two, factional politics align Xi Jinping more closely with Wang Qishan. Only time will tell whether that means Wang will play a stronger rule due to Xi Jinping's backing, or if that will cause Li Keqiang and other populists to see him as a threat and look for ways to reduce his influence. Those popu-

lists will include soon-to-be retired Party General Secretary Hu Jintao, who can still engage in political machinations behind the scenes and who has an interest in protecting his protégé Li Keqiang.

Then there's Guangdong Party Secretary Wang Yang, who is often lauded as a liberal reformer, partly because he has portrayed himself as the opposite of Bo Xilai. Whereas Bo called for a return to the socialist ideals of the Mao era, Wang Yang advocated a more liberal approach and argued that the only way forward was more political reform and liberalization, not less. His reputation as a modern thinker hit a high point this past fall during the Wukan protests. As party secretary of Guangdong Province, Wang Yang is the highest-ranking official in that region, making him responsible for resolving major protest incidents. Many foreign observers credited Wang for the relatively soft response in Wukan: Instead of sending in paramilitary troops, he sent in negotiators and held elections.

It is important to note, however, that Guangdong is always a bit more liberal than other regions in China. Guangdong residents joke that when new cadres are appointed to Guangdong, they start out as hard-liners, but after a year or so they relax and learn to adapt to the local conditions. Guangdong was the first region that Deng Xiaoping opened up to the West. It is much closer to Hong Kong than it is to Beijing, and it is one of China's most prosperous areas. All of those factors give local political leaders a lot of slack.

Even under those conditions, however, Wang Yang has not rolled out any major reform programs. The reforms Guangdong has announced in the past few years—such as Guangdong's new and more relaxed registration requirements for social organizations—have so far turned out to be more rhetoric than substance.

The biggest problem is that among all of the likely appointees to the next standing committee, none appear to be big thinkers like Deng Xiaoping, and even if they were, none appear to have enough political might to push those ideas through the system. Instead of pushing bold change, the next group of leaders will probably try to continue tinkering around the margins of the current system, just as Hu Jintao and Wen Jiabao have done for the past 10 years.

But another decade of marginal reforms may not be enough. At some point China is going to hit a breaking point, a point where marginal reforms are no longer enough to satisfy the people's demands. That would most likely be triggered by a major corruption scandal involving the top leadership or prolonged economic

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stagnation. Either of those events would shatter the grand bargain holding all of this together, which is that the party keeps the economy growing, and in return the Chinese people allow them to keep their stranglehold on political power.

Whether the current leaders can keep muddling along as their predecessors did, therefore, depends to a large extent on the Chinese economy. They have to get serious about economic reform and successfully rebalance the economy to avoid being pushed into major political reform. Their ability to do that will have serious implications for the Chinese people, and also for China's relations with the United States, Asia, and the rest of the world.

# Conclusion

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## The United States needs to better understand China

From a U.S. perspective, we need to prepare to deal with a China that is increasingly divided and uncertain about its future. Going forward, different Chinese leaders may send very different signals about where the country is headed. That will require U.S. policymakers to spend more time examining and understanding what exactly is happening in Beijing and what the Chinese leadership is facing at home.

At present, at almost every high-level leadership meeting between the United States and China, it is a fair bet that the Chinese know more about what is going on in the United States than vice versa. That is partly because the United States has a more transparent political system, but also because Chinese leaders consider our nation to be their most important counterpart. Beijing therefore places a very high priority on understanding our society and our federal system. That prioritization and attention is not fully reciprocated.

To be sure, we have top China analysts at the State Department and in other government agencies who do a very, very good job of tracking what the various elements in China are up to. But we simply do not have enough of them.

Until recently, that has not been a major problem because as long as the Chinese Communist Party spoke with one voice, China has been fairly easy to deal with. Now, however, the party is becoming more fragmented both in Beijing and around the country. There is a huge amount of confusion and indecision in Beijing over how to deal with China's growing challenges.

All of these multiplying voices coming out of the party are making China a more complex foreign policy partner. The United States will have to get smarter and learn to deal with this new dynamic. U.S. policymakers must develop a better understanding of where individual Chinese leaders, bureaucratic agencies, and regions stand on critical bilateral issues. Approaching China without that understanding would be

like approaching the United States without knowing the U.S. Democrat/Republican party divides or the different roles of state and local governments and the federal government. It could easily lead to major foreign policy miscalculations.

The United States will also need to keep a vigilant eye on China's domestic problems and be prepared to deal with any Chinese leadership attempts to deal with those problems by pointing accusing fingers abroad. When Chinese leaders fail to meet citizen demands on critical domestic issues, one way to deflect blame is shift the public's attention toward foreign disputes, especially those involving the United States.

On economic issues, for example, the Chinese Communist Party propaganda machine may blame slowing economic growth on U.S. import tariffs, U.S. refusals to share key technologies, or an international trade system designed to benefit the United States and other developed countries at China's expense. If the United States is to keep these types of accusations from triggering major bilateral conflicts, we will have to deploy a steady and knowledgeable hand.

Similarly, the party might turn to military jingoism to deflect rising domestic anger, pushing already well-developed nationalist buttons in the state media and even in the independent social media by paying people to post comments online. Government-paid Internet commenters are so common in China they are now known as the "fifty-cent party"—in reference to the amount of money they reportedly receive for each pro-government posting.<sup>58</sup>

The 2008 protests in Tibet demonstrated how quickly Chinese leaders can use nationalist rhetoric to throw the Chinese public into an antiforeign furor. The Tibet protests attracted a huge amount of media attention and sparked a wave of international criticism over rights abuses. The last thing Chinese leaders want to discuss is Tibetan complaints about rights abuses under Chinese Communist Party rule, so they framed the international criticism as a case of Western nations (particularly European nations) interfering in China's sovereignty and territorial integrity. Chinese citizens responded by rallying behind Beijing and staging nationalist protests at home and around the globe.

That is very dangerous, because once Chinese leaders whip their citizens into a nationalistic fury they then have to take a very hard line to avoid appearing to cave in to foreign pressure. To avoid unnecessary conflicts and steer the U.S.-China relationship through these challenges, U.S. leaders will have to learn more about who they are dealing with. There is no way around that. In particular, U.S. leaders need to better understand:

- China's elite leadership politics in the broadest sense of the term, including leadership transitions, the formal and informal norms that guide political behavior in China, and the factional politics that may grow increasingly contentious over the next 10 years. China's power dynamics are complex, but the only way U.S. leaders can understand how their Chinese counterparts will behave on the policy front is to understand the chess games they are all playing behind closed doors in Beijing. China has long followed U.S. elections and congressional scuffles to predict what our leaders will do. It is time for us to do the same.
- The problems Chinese leaders are facing domestically and the policy tools they have (or do not have) at their disposal.
- The dynamics between central and local government leaders. Beijing makes a lot of promises, but local governments are often responsible for carrying them out, and they do not always do so. On issues such as intellectual property enforcement and export subsidies, most of the action is at the local government level. The United States needs to develop better approaches to those problems, and the way to do that is to develop approaches that take China's central-local enforcement problems into account.
- The Chinese citizens' increasing demands and the challenges Chinese leaders face when they attempt to meet those demands without democratizing. Beijing's ability to do that will determine how long the current system can last.
- How China views the United States—both at the elite level and among the populace—and how domestic issues impact China's foreign policy behavior.

Chinese leaders are master strategists. They have to be to make it up the ranks in the Chinese Communist Party. They apply those same tactics to their dealings with the United States, and one of the first things they do is to get to know their opponent very, very well.

Washington is not a utopian playground—our own politicians are also very good strategists. It's time for us to follow China's example and apply the skills we have developed at home to better understand our foreign policy partners abroad. That is the only way we can manage this relationship and protect our interests while China deals with the challenges ahead.

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## About the author

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## Endnotes

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