

## **Panel II: China's Domestic Scene**

**Moderator, J. Stapleton Roy**

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STAPLETON ROY: Good afternoon. My name is Stapleton Roy and I'm going to moderate this afternoon's panel which deals with China's domestic scene. I think it is no exaggeration to say that this is really the key subject of the conference, because what happens domestically in China is not only going to be vitally important to the future foreign policy of the Bush Administration, but it also is going to have a major impact on China's foreign policy. So, in a sense, it's directly relevant to the other topics of this conference.



Naturally, we have scheduled this right after lunch, so that most of you will sleep through the presentations but that illustrates the importance of the topic that we are going to address. When I get back to New York, I am going to be attending a breakfast which will address the subject: "Is China a Google or an Enron?"

Those of you who read the business pages of the newspapers will understand the implications of that topic and we have here a world-class group of specialists who can answer that question for us. So without further ado, let me ask Professor Lieberthal, who I have known in so many different capacities that I have to look at the program in order to remember that he is a Visiting Fellow at The Brookings Institution.

### **“Making the Chinese System Work Better”**

**Kenneth Lieberthal, Visiting Fellow, The Brookings Institution**

KENNETH LIEBERTHAL: Thank you very much, Mr. Ambassador, it's a real pleasure to be here. I think the morning session got us off to a terrific start and the lunch presentation just expanded our scope and teed up this afternoon very well.

I have been asked to talk about making China's political system better. Frankly, the political system in China has performed really extraordinarily impressively over the last 25 years. It has managed to implement, in an



authoritarian system, major changes in its own processes of political recruitment, of policy-making process and the goals of the system itself in the internal distribution of authority within that political system and in the systems relations to the economy and to the society. And it has accomplished all of this without any fundamental breakdown and at the same time, while producing what all would acknowledge to be an economic miracle. That is a very, very impressive record.

The top leadership, moreover, has time and again identified and frontally taken on the major challenges that the country faces. This is not a leadership that has ducked the tough issues over time. But still, as we saw recently at the fourth plenum, as we see from a larger discussion in China, the leadership recognizes that they have now created an economy and a society that requires substantial additional changes in the political system in order to keep up with the products of their own success.

I have been doing some work on what are plans and priorities that they are pursuing, and what are their presumptions and concerns. Let me say the work on this at the highest levels of the Chinese political system is wide-ranging and very serious and in many ways very sophisticated.

Given that we are each limited to ten minutes here and I have used two minutes just teeing up the topic, I want to focus on only one of the issues that they confront, the one that I think is more fundamental than most and whose success or failure will drive a lot of other things at which people tend to look. Let me lay out that issue as follows:

To date, the core dynamic of the reform strategy over more than the last 20 years, has been really a very simple proposition. It has been to allow officials at every level of the political system increased flexibility on the proviso that they use that increased flexibility to effectively make their local economy -- an economy under a functional department or under a geographical administration -- grow.

If the economy grows, officials are rewarded in two ways: 1) Performance evaluation, which is largely based on economic growth, so they qualify for career advancement; and 2) Personal enrichment, either directly or indirectly through relatives or through serving on boards of companies or a variety of other means which has provided additional incentive obviously for officials to really work very hard on this.

The result of this is in part the economic miracle in the past 25 years. It has been a brilliant strategy frankly. But beyond that this has produced a

bureaucratic, capitalist political apparatus that is highly entrepreneurial, but that, as of now, interferes in the Chinese economy on a universal basis at the level of the enterprise.

In other words, throughout the Chinese economy, officials get engaged, enterprise by enterprise, to use political power to advance the fortunes of individual enterprises -- not of every enterprise, but of a large number of throughout the country. This enterprise-level interference, in turn, has been the fundamental structure responsible for an increasingly negative set of results of which the Chinese are very well aware.

To me, the top of four manifestations is corruption. It is very hard to see how you eliminate corruption when you have systematic interference with the level of the enterprise by officials.

Secondly, environmental degradation because the incentives are overwhelmingly to increase output even in the face of other admonitions to pay more attention to environmental concerns.

Thirdly, local protectionism; officials are delighted to have products come in from other areas, so long as they don't compete with the products of the enterprises that they are involved in. When they do compete with those products, they find a lot of ways to keep the competition out which has the effect of fragmenting the Chinese markets. Instead of getting the advantages of major regional and national markets, you have a lot of local markets that are really difficult to penetrate.

Fourthly, a failure to seriously punish violations of intellectual property rights because, after all, in this kind of system, pirate firms generate employment and income. Furthermore, they are as good as other firms in the mind of an official whose locality has pirates rather than the originals. Given the way the Chinese legal system works, when a judgment is reached against a pirate firm, it is up to a local government to implement that judgment and the local governments find a lot of ways to blunt any serious disciplining of pirates within their own jurisdictions.

Now, China is obligated by the WTO and frankly, as my comments would suggest, by their own interests to shift to a different type of government relationship to the economy; that is, to shift to the kind of relationship to the economy that is characteristic of every advanced economy in the world. That is a relationship where the government focuses on macro-economic issues; by monitoring fiscal policy, laws and regulations, and central policy.

Let's face it. Most governments help out some individual enterprises of particularly powerful individuals -- I was not thinking Enron at the time. It is not

systematic. That is the exception, not the rule, so marks a fundamental change from the current system in China.

I think the Chinese leaders are very well aware of their need to move in this direction. This is not something that they are blind to. The problem that they confront is very simple. This will be the first time since the reforms began that, in a major way, top level officials are going to say to people down the line: “the next step in reform is going to take money out of your pocket, not put more money into your pocket.” So, the next step, for many people down the line, is going to adversely affect your personal interests, even as it promotes the structural requirements of the system as a whole.

Frankly, to me, therefore, it's not clear how this is going to come out. We aren't talking about a single decision that will be implemented in a year or two, but rather about balance over the coming decade. How much of this dimension of this Chinese system will shift from systematic intervention by the government at the level of the enterprise to a much more limited role for the government, focusing on macro-economic intervention?

One of the key issues here clearly is the distribution of interest that has grown upwards as a result of the reforms. The reforms, having been in place for 25 years, has now created a whole system. That system has a distribution of interest that makes it not always easy for top leaders to take decisions that are unpopular with local level officials and have those decisions implemented in a meaningful way. But failure to make this key change successful will bode ill for China's future in terms of corruption, development of national level markets and environmental sustainability.

More fundamentally, I think it would raise the possibility that developments in China will eventually challenge the global business model for technology innovation. China stands a possibility of becoming the world's second-largest economy to use current managerial drive, and the world's second-largest economy whose core competence would be theft of intellectual property. The production of pirated goods, to be exported around the world, will provoke an enormous response in the international trade regime and also challenge a fundamental regime globally for technology innovation. If you cannot protect new technology, then you don't have an incentive to invest in new technology.

I'll just take one more minute, Stape, I will finish on time. I feel his heartbeat getting a little faster here. Stape and I have known each other a very long time.

China has serious plans to improve the quality of its government, to make its system work better as it seeks to build its wealth and power over the coming two decades.

Since I have only focused on one issue in these remarks, let me just say in broad terms, its underlying models are the ROK, Taiwan and Singapore of the 1970s, I believe that you need a strong relatively efficient government devoted to breaking eggs to make its economic omelette in order to produce the economic growth combined with overall stability that the country, in their view, requires. It will be for the next generation to then take on more fundamental political changes if they choose to do so.

My own feeling is, as suggested by the substance of my remarks, regardless of whether the other parts of this overall approach make good sense, if China does not manage to back off from systematic official interference at the level of the enterprise, I think the rest of their plans to make the political system work better will produce results that, frankly, they themselves find disappointing and the rest of the world would find very troubling. Thank you.

STAPLETON ROY: Thank you. For a one issue presentation I think that Professor Lieberthal managed to touch on a remarkable range of inter-related issues.

Gordon Wu, obviously needs no introduction in Hong Kong but for those who have been asleep for the last thirty years, he is the chairman of Hopewell Holdings Limited and he will address the question of improving the Chinese system and Hong Kong's role.

**“Improving the Chinese System and Hong Kong's Role”  
Gordon Wu, Chairman, Hopewell Holdings Limited**

GORDON WU: Thank you, Roy. Stapleton Roy, I've always gotten him wrong, I thought he was always Roy Stapleton.

STAPLETON ROY: I still am to many people.

GORDON WU: This topic probably requires ten days of seminar and I am trying to do it in ten minutes, so if I appear to be only scratching the surface please understand the time constraints.

When you talk about the system, there are actually several systems. I can talk about the political system, the financial system, the commercial system, the judiciary system, etc.. I do not know where to begin, but I will pick up from where Ken finished -- the political system.



Yes, the Chinese political system is very autocratic. What Chairman Mao had said gave meaning to the phrase “the Great Leap Forward.” Normally, people look before they leap, but Chairman Mao leapt anyway, into the Great Leap Forward, into the community of cultural revolution which were economic and political disasters. But anyway, may peace be with him. Now, China is different.

But on the other hand, we have seen autocratic systems that do work. If you look at the Catholic Church, it has been around for over 2,000 years and it is still going. Therefore, what China is doing is okay. China is gradually absorbing the ideas of the successful systems, but I will not get into that. I will jump to the next system -- the judiciary system.

I noticed that Chairman Mao Zedong never trained any lawyers -- good for him. But on the other hand, if you are going to impose the type of laws that Ken spoke mentioned, even if you get a judgment, you need a bailiff system to collect. In China, there is no such thing as a bailiff. As a matter of fact, even before the implementation of a legal system, first of all, you have got to have the People’s Congress pass a constitutional amendment. Then you have to create the laws, and then train the lawyers, advocates, judges and what not. Imagine the size of China, how many years of experience and preparation until you can have adequate judges?

Just looking at the wild west of America during the 1800s, we’re talking about the kangaroo courts, about the corruption era, about the undeveloped U.S. court system. Similarly, the Chinese legal system, in its early stages, is far from perfect. The U.S. had to train many lawyers and judges, something China will have to do as well.

I must warn you that the Chinese legal system is far from perfect. Take England, for instance, the Magna Carta started in 1215 and over 700 years later, they are still sending delegates to Westminster trying to pass the laws there. Therefore, it is going to be an ongoing improvement. Do not expect it to perfect itself overnight.

The next system I want to talk about is the banking system. The best banks in the world pride themselves in announcing that they have an 8 percent equity rate, according to the Bank of International Settlement Rules. In Japan, they only have Japanese banks. Although in the 1980s and 1990s, roughly nine out of the ten big banks were Japanese. These nine banks were always struggling on this 8 percent figure and I am sure they even cooked the books to achieve that. Whenever there is a financial crisis, it is always the banks that get hit and then that 8 percent is no longer sustainable.

If you look at the savings and loans fiasco in the U.S., the Asian financial crisis, the Japanese bubble, all of these evaporated a great deal of the equity of their banks, but different solutions were used to solve basically the same problem.

In the U.S., the U.S. Congress pumped a lot of money into the system to sort that one out. In Japan, they pretended that the problem would go away on its own, but after ten years, finally, they had to merge banks and also inject equity.

Now, how does China deal with the banking problem? Despite the fact that saving rates were probably 40 percent, China probably had a bigger problem. They had plenty of money coming in, but the banks were basically finished. So, Premier Zhu Rongji pumped 300 billion Yuan into the system. He arrested corrupt bankers and sentenced them to death -- capital punishment is still practiced in China. Lately, it is not uncommon to hear: Why don't we let the stock exchange regulate itself? Thus, many state-owned banks are going to Hong Kong to get listed through IPOs on the Hong Kong's stock exchange. They do not want care for the money as much as the corporate governance bit of it. So, this is a different way of solving their banking problem.

Look at the financial system, one thing that the Chinese learned very quickly was taxation. As a matter of fact, there is over-taxation because different departments have created different names and different systems to collect money from the Chinese and this a concern that the Central Government is trying to put limits on, but nevertheless, they are not lagging behind in the talent of collecting taxes.

They have, I thought, a unique system and I was told I was very wrong. The provinces do the actual collection, and at the end of the year, each province negotiates with the Central Government on what percentage the Central Government receives. Then the Central Government will redistribute that money and subsidize the poorer provinces such as Tibet or Guizhou. Shanghai and Guangdong often complain that they always end up paying too much tax to the Central Government.

The Central Government has a way of addressing this imbalanced distribution of money between the very rich coastal regions and the rather poor internal regions. When I said I thought it was unique, I was told that it actually was not because the Romans had the same system. I guess the Chinese learned very quickly.

There is also the question of corruption. Yes, corruption existed, but it is an age-old problem. If you read the Bible, our Lord has 12 disciples and one decided to work for 30 pieces of silver. They still have not solved that problem yet.

So, what is the solution? I think the solution is similar to the Singapore example. Lee Kuan Yew, someone I really admire, tackled the problem head-on. He decided, bend the rules. In the common law system, a man is innocent unless proven guilty. Lee Kuan Yew introduced the anti-corruption laws in Singapore. He said you have to prove that you are innocent which is the continental code. I

asked him personally, I said, "Look, you've got a double first from Cambridge, and you are a lawyer, how come you bend the rules?" and he said, "I have no choice, otherwise I would not get the convictions."

Hong Kong followed suit and I am sure China will follow suit as well. This brings us to the next question: What is Hong Kong's role? I think Hong Kong's role is to prove to China that Hong Kong has a system that runs relatively well. It is true that every country has its problems, but at least Hong Kong has a relatively stable and good working government. Hong Kong can show China, for instance, our basic rights of freedom of speech, our anti-corruption laws, and that even the people can sue government.

Actually in Hong Kong today, almost everybody seems to want to sue the Hong Kong government, and more often than not, the Hong Kong government loses. If we can show something like this here, and I am sure that in due time, China will understand that being sued is probably not the worst thing, or that having freedom of speech is not so bad either, but it will take some time.

If we look at the history of China, there is a long period of time that China is not ruled by the rule of law, but rather, it is ruled by the people. The emperor always had divine rights up until 1911. Dr. Sun Yat Sen said, "No, this is not good," and stated his three principles of revolution as nationalism, democracy, and equalization: "saam maan ji yuen." Change eventually came and in 1949, when Mao Zedong abrogated the constitution.

China really only began in 1979, with the rise of Deng Xiaoping. Deng reorganized the People's Congress and wrote the constitution, but there is still something I do not understand. I would like to ask a law professor: "How can a communist party come to be on top of a nation?" But anyway, that is what was written in the Chinese constitution and I am not going to start a revolution to change that.

I think Li Wing Tat, Yeung Sam, and all these people want to do that. Congratulations. Let them do their job. However, the constitution is something I am sure will be changed in future to be even more in line with outside countries.

I do not think I can really deal with all the nitty-gritty of the Chinese systems. I can talk on them for probably ten days and still will not have finished half of it. But Hong Kong's role is to set a good example, show China that we can co-exist with all the Western democracies, as well as the autocratic government. Thank you.

STAPLETON ROY: Thank you. Our third panelist is Wang Shaoguang, who is a professor at the Chinese University of Hong Kong. He will address the question of state and society.

## “State and Society”

**Wang Shaoguang, Professor, Chinese University of Hong Kong**

WANG SHAOGUANG: Mr. Wu just mentioned that under Mao there were no lawyers trained. I was among the first group of students studying law after the Cultural Revolution. But after four years of studying law, I was bored and therefore turned to politics. But today, I was asked to talk about the society. You should ask a sociologist, I think, so I had to do some homework. Here I report what I have to found out about the society.

I have a pretty simple proposition. In China, state institutions were largely designed for a society that was poor, immobile, rural, closed, mass associated, but equal and simple as far as social structure are concerned. That was the situation before the recent economic reform and probably stayed so through the late 1980s and early 1990s. But now, after 25 years of reform and openness, China has changed and become more prosperous, more mobile, more urbanized, more open, more associated, and less equal and more diversified in terms of the wage gap. Each of those changes, except the last two, were desirable. However, each of those changes presents challenges to the state's capacity to govern.



Let's first take a look at how China has changed in those aspects. First, China is more prosperous. People, for the most part, pay most attention to income. This figure includes both rural and urban incomes. The absolute yuan in the real wages, both in the countryside and in the city, the people's income has increased by 500 percent or more in the last 25 years.

Not many people pay much attention to living space, but that, I think, is also a major achievement. I remember just ten years ago, the government promised to allow each person to have an average of ten square feet, but now I am surprised to find out that in Chinese cities, each person actually has more than 20 square feet of living space.

Prosperity can also be measured by private ownership of automobiles. This figure dramatically increases after the early 1990s. In the last few years, in many cities, the growth rate of private cars is around 20, 30 or 40 percent a year. So, China has become more prosperous in that aspect.

A recent survey about the per capita wealth in China and its composition says that on average, each Chinese now owns about 25,000 or 26,000 yuan in assets including land, financial assets, housing, etc. In other words, most Chinese today have become property owners, one way or another.

The Chinese society has also become more mobile. A figure from Shanghai says that, in 1979, only about 3 percent of people living in Shanghai were temporary residents. By 2000, it is already 24 percent of the total population. I think it is still an underestimation. This is the situation in all of China.

In 2000, as seen in the most recent report, the total so-called floating population amounted to about 140 million a year. A lot of people are moving, more than in most of the European countries. This general trend of migration from the early 1980s until now, is constantly increasing. I think it will continue for another 20 or 30 years.

As a result of the migration, China has become urbanized. The proportion of people living in the countryside and in the city is obviously underestimated because there are many people who do not have a legal urban residency. Perhaps more than 50 percent of the population lives in larger cities and small towns in China that have become more urbanized.

As a result of urbanization, a lot of farmland has been lost. Each year, since 1997, the total amount of farmland lost increases. An estimated 40 million farmers have become landless. This is a major problem. The government is very worried about it because even those who have some compensation, it is simply far from sufficient. Many people complain about this and has led to many recent cases of unrest involved landless farmers.

Of course, China has also become more open. This is an economic measure in terms of trade as a percentage of the GDP or FDI as a percentage of the GDP. Even compared to Japan and the United States, those two proportion in China are much, much higher. If you use the exchange rate, China's foreign trade accounts for nearly 60 percent of the GDP. This is a relatively high percentage among larger economies.

Not only is there economic openness but there is a large number of Chinese travelling abroad. The number of people who travel for business is very much constant, but the number of people who travel for leisure has increased dramatically in the last few years and this trend will continue.

Another indicator of openness is the internet. Of course, there are complaints about the Chinese government blocking certain websites abroad, but overall, the people in China can reach a broad new world through the internet. By early this year, 80 million people in China will already have become internet users and the number is increasing at a rate of 20 to 30 percent a year. Soon enough, China will have over 100 million or the largest number of internet users in the world.

Another related development is that the Chinese have become more associated with each other. Recently, I wrote a paper titled "Association or Revolution in China." It has not yet gotten much attention from outside China. Many people still think that the government bans all kinds of associations. That used to be the case, but it is no longer true. I have found many estimates about different types of associations. If we included those that are governmental or semi-governmental, then the total number of grassroots associations amounts to 8 million. Even if it excludes those that are governmental or semi-governmental, the number is still more than a million. So, there is now a large number of people associated with each other.

In two surveys, people were asked whether or not they have joined any associations. This was a 1990 survey by University of Michigan Professor Eberhardt. In this survey, about 26 percent of the people said they joined at least one association. In 2001, I did a survey for the UNDP and we found more or less the same results. About 24 percent of the people had participated in at least one association in China. This proportion obviously is not very high compared to Western countries, but compared to many other societies, this proportion is quite high.

A survey conducted by the UCLA, over a number of countries suggested that the internet in many societies somehow reduces human interaction, but this has not been the case for China. In China, the internet actually increased human interaction especially among friends, people who have the same political interests, have the same religion beliefs, or have the same profession. In China, the internet served as a good service to that ended up promoting association.

One related development is that China has become less equal in terms of wages. But the Chinese are still very egalitarian. This, I think, is a socialist legacy. A survey, which compares China and many other societies, questions whether the Chinese are unequal. In other words, have the differences in income become too large? In a survey in Beijing, in 2002, 95 percent of the people say yes, China's inequality is too large, and thus is unbearable. Many people, 80 percent, believe the Chinese Government should set an upper limit on income. So, this inequality of wages is a kind of socialist legacy.

But in China, no matter which direction you look, inequality has been on the rise -- in rural China, in urban China, everywhere. If you use the Gini coefficient to measure inequality, it has been continuously growing in the last 25 years. China, compared to other countries with available data, has become one of the most unequal societies. The societies that are more unequal than China are mostly in two geographic regions: 1) Latin America; and 2) Sub-Saharan Africa. Otherwise, most countries are seem much more equal.

In the past, the Chinese have always said India is a very equal society, in India, the Gini coefficient is 0.32, and in China it is nearly 0.45. This is wealth

inequality, not income. Wealth compare all kinds of asset ownership. The lower 10 percent of households owns less than 1 percent of the total assets, while the top 10 percent of households owns more than 40 percent of the total assets in China.

There is also a dimension of urban-rural divide in distribution of income and wealth. As you can see, 98 percent of the lowest 10 percent of households were in the countryside, only 1.3 percent in Chinese cities. Rich people, on the other hand, mostly are in the city and very few in the countryside, both in terms of wealth and income.

Related to this is that the Chinese society has become more diversified. This is a comparison of the social structure in 1978 and the year 2001. As we can see, in 1978, the social structure was relatively simple. Most of the people were simply living in the Chinese countryside. They were members of people's communes, a very simple social structure. But, by 2001, the Chinese society had become very diversified. Many new classes have emerged and old classes have experienced either upward or downward mobility.

One of the consequences of the diversification of the social structure is that a new social conflict has arisen. I used a couple of different indicators of social unrest or social conflict. The benchmark is the index of the GDP. Compared to 1996, by 2002, the GDP index is 153. If you take the number of civil disputes, labor disputes, especially collective labor disputes, the criminal cases registered and accepted, the growth rate is much higher. In other words, the economy was growing but the number of conflicts was also growing. So that is the Chinese society.

We can make a number of very simple observations. All the social changes and long-term trends are almost irreversible. All the social changes may be positive except for the last two, inequality and diversification. However, each of those presented challenges to the government's ability to govern.

I will summarize the possible challenges from each of the social changes. For instance, more possibilities. There is a stress of energy resources when more and more people become car-owners and consume gasoline. China now imports 40, nearly 50 percent of oil from abroad. Domestically, discussions about oil reserves in China creates a possible challenge to the government concerning environmental damage. With more money and wealth, the people have a stronger desire and ability to participate in politics. That could also be a challenge.

I do not think I have the time to go into the details of each of those, but in any case, good, desirable social changes can also present challenges. That is my point. I think many people have ignored this part. They only focus on bad developments and its political implications. Here I emphasize the good social, economic developments that can also be troublesome for the government. Thank you.

STAPLETON ROY: Fortunately, we have quite a bit of time for questions and discussions. I thought I would kick things off, however, using my moderator's prerogative, by picking up on Professor Wang's presentation, which has rather dramatically demonstrated the implications of the economic growth and the collateral changes in China.

I would like to ask one or more members of the panel: would you be prepared to comment on the implications of continued sustained rapid growth in China for political change? Professor Wang mentioned that it challenges the government's ability to govern, but my question is: How will the government respond to that by adapting its mechanisms of government to the new challenges that are emerging?

KENNETH LIEBERTHAL: I am happy to kick that off. In fact, I realize that Wang Shaoguang should have gone first, because I started off saying changes in society, in the economy have made the government realize that they have got to change the political system and then Prof. Wang has really provided a lot of meat to back that up.

I think that the broad outlines of how the government is thinking about changing to adapt to this situation should include the following: that the government is prepared to have society do more work in governing itself, which is to say more extensive development of NGOs; even developing philanthropic organizations and organizations themselves have funds to allocate to social purposes; shrinking the size of the state apparatus, making it more transparent, higher quality through better recruiting, better training and more rigorous and transparent promotion procedures.

I think that their attitude towards the media is that the media should become more interesting, and therefore, more commercially viable by meeting real popular demands but should not be free to criticize the political authorities in a way that might undermine their legitimacy, so ongoing censorship of the media but with a livelier and more diverse media.

I think in the economy they are looking to privatize on a very, very large-scale, retaining control over about 190 or so major enterprises, many of which they hope will be leaders in their various economic sectors but with the rest to be sloughed off in one way or the other through privatization processes.

So, the idea is that the government will eventually focus on being able to make the tough decisions that are necessary to enable the country to continue to develop rapidly economically. Privately, we will say, take the negative example of the recent Indian election which showed what would happen if you were to get pushed back from the pace of economic change.

My question that I would raise and be delighted to have anyone pick this up, is whether there are two aspects to this approach that really need to be considered. One is simply scalability. For example, South Korea, where you had a fairly strong authoritarian government that tried to work effectively to build the economy and let the economy develop under non-governmental auspices and then eventually democratized after that. But South Korea is the size of a Chinese province. And the question is whether you can have that kind of model apply over the coming 15 to 20 years in a country as large, and especially as regionally diverse as China is.

The second question is information. We are now globally just at the first generation that is wrestling with the IT revolution and the ubiquitous availability of information. I do not think anyone yet knows how that affects the ability to govern these kinds of processes but my guess is that effect will be substantial and we will have to see how it unfolds.

So I think that is a broad outline. That is where my concerns are just in terms of some of the fundamental difficulties in realizing that vision.

GORDON WU: I think the PRC is copying the example of Taiwan and in some ways copying the example of South Korea. Let the economy develop under stable conditions and their definition of stable conditions means under their strict control. Taiwan was like this. They were so tough in the 1950s and 1960s. If you criticize Chiang Kai-shek, you wind up on a little island called the Green Island and disappear from the world. I counted in the late 1970s, there were something like 15 U.S.-trained Ph.D.s on the cabinet, and I predicted that there would be democracy in Taiwan. Shortly before Chiang Ching-Kuo died he said, "We are going to have democracy, general elections, blah, blah, blah."

I believe that democracy should be an evolutionary process and not revolutionary. If you look back at the history of America, if Thomas Jefferson was a hothead and insisted on voting in the summer of 1776 when he drafted that declaration of independence, I am sure that there would not be a United States of America. It would be Divided States of America. He would never have gotten the Virginia Legislature to pass what he wrote but he set the goals and said, "Look, these are our goals and we are going to work towards it." And couple of hundred years later, I think America is still working at it and probably 99 percent done but there is still one percent not done.

So I think the Chinese political system will be something like this. Under stable conditions, under their control and after a while, when you get the education level up and when you get the economic level up and also the internet and the jet planes and all these things that will help to bolster the arrival of universal suffrage.

STAPLETON ROY: Professor Wang, do you want to comment at all?

WANG SHAOGUANG: Yes, I think after 25 years of reform, also exposure to the ideas of the system elsewhere, many Chinese have now become more matured politically speaking, compared to, for instance, 1989. While for the indications, I think many intellectuals have come to the realization that the problems China faces, many of those problems cannot be resolved by simply democracy, introduction of democratic systems, freedom.

Rather, you need something else. They can point to the case of India, Philippines and other countries. They are democratic, they have free elections, they have freedom, a free press, but there are still many problems. In terms of the future change, many people suggest what China needs is a democratic state building.

On one hand, you need the introduction of a more democratic element into the decision-making process, but in the meantime, you have to strengthen the government ability, for instance, to regulate and to redistribute. Those capacities can be developed independently from democratic institutions or free press for instance.

STAPLETON ROY: Okay. Yes, could I ask you to identify yourselves, please?

QUESTION: Certainly. My name is Tomohiko Taniguchi, CNAPS Fellow this year, Brookings Institution. I think what is conspicuous in its absence is the discussion of the role of the Communist Party. Everyone knows that the Chinese people are very pragmatic, so I would assume that there has to be a pragmatic role that the Chinese Communist Party still plays. Let's take an example of a company like Wal-Mart, which has decided to let the workforce unionize. Can any one on the panel comment on what party members will do in such an environment as Wal-Mart, for instance?

KENNETH LIEBERTHAL: I'm going to stay away from the Wal-Mart side of that question, but the role of the Communist Party is very clear and very simple. It's to be the glue that holds the system together and specifies the direction in which it will head. If you look, for example, at the discussion of things like separation of party and government, which was something that was talked about a lot some years ago, the recent commentaries that you read on that make that very clear: separation of party and government means that one person can hold a key position in a party and a government post simultaneously but when he or she acts, wearing one hat or the other, they will act only wearing that hat.

So, to my mind, that isn't separation of party and government. That is party government schizophrenia, taking the division and putting it inside one person's brain. So the party has to remain the core of this. The party is to be the politics of China, if you will. There is a lot of debate about what should go on within the party, but fundamentally, if the objective of this is to drive the country

in a direction where you can keep your eye on the developmental ball, the party is supposed to be the driving force behind that.

STAPLETON ROY: Professor Wang?

WANG SHAOGUANG: China is still a party state, but the content of the party state has been undergoing change. 20 years ago, the party and the state were probably identical. You could find many parallel organisations, both in the state institutions and in the party institutions, for instance, within the party, the Committee on Agriculture, for instance, and its counterpart was the Agriculture Ministry. Still today, in the party state, there is some overlap, but to some extent, it has been separated.

The party, the main role, today, I think, is what Ken just mentioned, it's a kind of a glue in the whole system. In other words, it integrates the whole system, focusing on some key areas. One is ideology. That is why there is still the "*Xuanquan Bu*," sometimes translated into Propaganda Department. Now they have changed the name to Publicity Department. And there is the Organization Department to control the key appointments in the government, in the economic organisations. Another is the Chinese Central Military Commission, to control the military. So the party now focuses on certain key, narrow areas rather than intervenes into every aspect of the society and the economy.

GORDON WU: I am probably the least qualified to comment on that, but I will try anyway. There is no harm in trying. I think when you look at the Communist Party, I see their role as something like the pope and the cardinals of the mediaeval Europe. It is like the mullahs of the Muslim world. And when I saw Aida, it is like the high priests.

This is what it is. They are the controlling mechanism. Normally, in a what you call a rudimentary state of government, these people probably exist. When you look at Japan, the LDP for all these years has been ruling Japan as the de facto ruler, but at the end of the day, when the people increase their aspirations and economic levels of development, and also intellectual levels of development, then the Western ideas of equality and universal suffrage comes in. I think China will change, but I don't expect it to happen in the 2004 or 2005.

QUESTION: Ruth Shapiro from the Asia Business Council. I have a question for Professor Lieberthal, although if you have other comments, please chime in. When you hear about problems in China now, whether it is cooling down the economy, it is AIDS, it is the environment, the answers come out of Beijing, "We're working on this," Hu Jintao, "We're working on this," Wu Yi, "We're working on this," Wen Jiabao, "We're working on this."

But when you travel around China and you meet officials from Guangdong and Shanghai, what are they saying? "Invest here, we've got a new

airport, we've got new roads, we've got this, we've got so much money." There are no messages at the provincial level of any problems in the system that often come out.

So my question is: For provincial government officials, what are their sets of incentives? What is it that Beijing is looking for them to perform on, such that they get moved up?

KENNETH LIEBERTHAL: That is a very good question. The answer to that question is now in the process of changing. There is a cadre-evaluation system in China. Every cadre, every official is evaluated annually on that system. If you look at the composition of the system for evaluating cadre performance, more than half the points each year were allocated to various indicators of GDP growth. So when you get "come here and invest here," that is exactly what, on balance, incentives have been. There are minor parts that are on the environment, on public health, more than a minor part has been on birth control, but the biggest single thing by far has been GDP growth, and so that is what you have gotten.

They are now restructuring the cadre-evaluation system and they are going to build in very soon, I am told, much greater attention to things like sustainable development and measures of sustainable development and various measures of social well-being. That will touch on public health and delivery of services and that kind of thing.

One big problem is: how do you get indicators of that that are meaningful on a short-term, year-by-year basis? I cannot pretend to know whether the new system will in fact remedy the problem in a serious way, but as of now, what you have been running into is exactly a rational people responding to the incentives within the system.

QUESTION: Hi, (inaudible) from the Economist. This is a question for Ken Lieberthal. Given the inability of the Chinese Government to leave its companies alone, interference at the enterprise level, as you described, can China really fulfil its other desire, which is to build world-class companies? Putting it another way, if a company cannot risk spending decades investing in technological development because the political system is so unpredictable, can China really produce a Samsung or a Sony, a world-class company?

KENNETH LIEBERTHAL: It is a very good question. I think that if you look at the Chinese economy, some of the biggest problems in the economy, in the wholly Chinese enterprises, not the joint ventures and that kind of thing, is in corporate governance. The level of corporate governance is not high. I think it is very hard to get globally competitive firms if you do not understand how you optimize across the entire value chain.

Forgive the jargon. I'm also a professor of business administration so I hear these kinds of phrases all the time but essentially you have to really focus on how do I squeeze maximum value out of the array of resources that I have -- financial, managerial or physical resources, marketing opportunities, after-sales service opportunities, etc. -- and the way the Chinese state firms are now structured, they're not structured in order to optimize cross that array of issues at all.

And the way they're staffed, as Wang Shaoguang mentioned, you have an Organization Department in the Chinese Communist Party that ultimately has patronage control directly or indirectly over top positions and most of the enterprises. That doesn't mean that they won't select some very good people; I think they seek to select very good people. But it is one thing to be selected strictly by performance and the dynamics of the business community and it is another thing to have a political sign-off on that. That changes your incentives and you get sometimes not very business-friendly results of that.

So, I do think that until they are able to move back the government more out of the economy, especially at the micro-level, firm-level interference, the only way they are going to get internationally competitive firms is by subsidizing them with the taxes of Chinese citizens.

GORDON WU: I think we see the first step. Do not forget that modern-day China, from only after Deng Xiaoping said to open doors and reform, China is only 25 years old. The first step towards this corporate governance is the IPO of the state-owned banks coming to Hong Kong and the express purpose is for this corporate governance.

QUESTION: Thank you very much. Richard Bush, The Brookings Institution. Of necessity, all three of you talked about problems and challenges as if they were uniform across China. I am the one who set the ten-minute limit. I will take responsibility for that. But I wonder if you could talk a little bit about the diversity of China and the extent to which these problems and challenges are experienced differently in different parts of the country. Is the regime actually taking account of the way it is conducting changes to the political system or might it if it is not doing so already?

WANG SHAOGUANG: Years ago, I wrote a book about regional disparities. Now, I am using information from my book about the regional disparities rather than updated research. China is a large country. If you measure it by, for instance, per capita income across the provinces, the gap is probably the largest in the world compared to any country. One of the contributing factors is the size. Another is the geographic landscape. That can explain a great deal of differences.

In the last couple of years, I have travelled to some inland and Western provinces. What impressed me was the differences between cities that were not

so large. I went to a small town in Tibet. I was surprised. It was a modern town, very modern. There had been a lot of construction done. I had no idea of that until I arrived there. I also travelled to a large part of Gansu last year. I saw construction in almost every city. So mostly, the gap between urban and the rural areas rather than between regions.

Of course, there is a difference in Shanghai from Xian or Xiling. But if you go to Xiling and Xian, the cities have modernized and every year there are new change. I am from Wuhan. I was surprised to learn, just last month when I returned to Wuhan, there was a large 30-mile long park was built. I did not realize that until I was there. So, the big difference is in rural China and urban China rather than by region, I think.

KENNETH LIEBERTHAL: Let me just add a note to that. It is a very good question. It is not an easy one to get your arms around. I very much agree with Wang Shaoguang's comment about the biggest difference being between urban and rural and that shows up in the statistics if you break them down that way also.

But having said that, there are tremendous differences in the core issues in China, region by region. Probably North China's biggest single challenge is water. In North China, the water table has been dropping 3 feet per year, a meter per year, every year since 1960. They are literally running out of sufficient water to sustain their current population level and economic activity. If you go to the central part of China and I think their biggest problem is their agricultural base; especially, as China opens up its agricultural markets, they are not competitive internationally.

So, you go area by area, and the core issues change a great deal, and you see some big regional issues, "open up the West" policy, and now a North-East West policy, so you see some tailoring in order to cope with these differences. I just have this underlying sense that the differences are much greater than the system is allowing for, because the differences also extend, if you look at it region by region, even fundamental economic structures differ enormously.

There are provinces in China that are dominated by the state sector. There are other provinces that are virtually wholly private economies at this point. There are provinces dominated by heavy industry and others by light industry. There are others that are almost wholly agricultural. I just get the feeling that there is more uniformity than the underlying reality should encourage.

STAPLETON ROY: You see the possibility that China will be outsourcing all of its farming jobs to the United States?

KENNETH LIEBERTHAL: I will tell you in grains and soy beans, I think it is likely to.

GORDON WU: Excuse me, I want to put my two bits in. I remember my undergrad days in the 1950s in America, I went through Kentucky and Tennessee and I learned the word "hillbilly." At that time I did not understand what that meant. Now, when I go through Kentucky, and there is a Honda assembly plant there. So, in addressing that, the difference there I think is probably transport, television, information, and travel. I think China did do one thing better. In the taxation system, the Central Government is allocating subsidies year to the provinces. We've got to have a little bit of patience. Do not forget this is only a country which in my mind is 25 years old. I think it has done remarkably well, because 25 years ago, the private sector accounted for less than 5 percent of the economy. Now, it is the majority.

QUESTION: Robyn Meredith of Forbes. I wonder why we are seeing a lot of press reports out of China about a huge number of protests, social protests, protests over dams being built or farmlands being bulldozed, etc. It seems to me in the last few years you didn't see those. Are actually more protests being allowed, and if so, why? Or, is the press being allowed to report them, if so, why? Or, are we just seeing the fomenting of much more frustration along the lines Professor Wang talked about?

STAPLETON ROY: Professor Wang, do you want to lead off on that one?

WANG SHAOGUANG: Yes, I have also read many stories about the recent protests. In fact, in the last few years, I have suggested that more small-scale protests are good for China, and China probably will want to have more small-scale protests rather than a big one. I think it is a good sign rather than a bad sign.

If you read those stories carefully, you may come to the conclusion that many of them involve landless farmers. They have lost their land. In terms of, for instance, the protest of the dam construction. The main issue is still that they are not very well compensated. In urban areas, the real estate developers sometimes strip land without enough compensation to the resident. That becomes another source of unrest.

So the issue is very specific, not so much political, and mostly related with real-estate development and urbanization. That is my observation and in my view, this is probably good. If local governments learn how to deal peacefully, with the social unrest, eventually if there's a big one, they will not use the same method they used in 1989.

KENNETH LIEBERTHAL: I want to highlight a theme that Wang Shaoguang established in his formal remarks. China is the most rapidly changing place in the world. It is undergoing fundamental shifts from rural to urban, from public to private, from the interior to coast, from a *danwei* based kind of plan-type system to a market-oriented system. The changes that occurred in most major countries over a period of 100 years are compressing it into 20 years, and we are in the

middle of that. If that did not produce a huge amount of protest, it would be absolutely astonishing.

The Chinese publish aggregate statistics every year on protests, and what you find is every year the number goes up by thousands. The average size of protest goes up considerably also, so this is becoming a much broader phenomenon, and the press reflects that. I think that part of the greater treatment of that in some of the press, reflects a very conscious political decision by the new Hu Jintao-Wen Jiabao administration that says "Yi min wei ben." Essentially, he is willing to focus on the people, highlight problems, and then show that he is prepared to try to solve those problems. I think there is a political strategy behind some of the press treatment of this, but obviously, they are very concerned to keep those protests scattered and small-scale.

STAPLETON ROY: Let me just throw in a question here. So far we have been looking really at a Google China, not an Enron China, and yet, we have identified a host of issues which are going to challenge the government's ability to change. What happens if the government does not meet the challenge? Is that a serious risk or is that a fairly low probability risk? I wonder if any of you would care to comment on that.

GORDON WU: I think whether people will be happy or not happy is a case of relativity. If you look at the Chinese economy, per capita income at the present moment is still well below the poverty line drawn by the United States on their own people. But when you ask the average Chinese national about that, they will say, "Looking back, we have never had it better in these 2,000 or 3,000 years of history."

Therefore, when they are happy, they do not tend to protest, except in Hong Kong. In Hong Kong, we have an average of about 300 protests every day. They are protesting all sorts of things that they against. So if you just read the press, you will think Hong Kong is a horrible place, but actually it is not that bad.

I think what will happen is that the Chinese Government, even controlled by the Communist Party, will be getting smarter and smarter and will be reacting to people's demands more intelligently. Of course, the worst government is a government that satisfies or tries to satisfy every faction. I think CH Tung has been doing very good at that. He is trying to satisfy everybody. In the end, he satisfies nobody.

So, therefore, the important thing is the rule of law has to come in and the rule of law unfortunately is not PRC's strongest suit. But let us hope in due course, they develop the law schools and they develop the people and they develop the spirit, and then the rule of law will help China be a better place.

QUESTION: Mike Elliott from Time. Just as a theoretical construct, is it possible to imagine a developmental state where local officials essentially get rewarded for pouring concrete without truly independent checks and balances like independent media and independent courts that does not result in endemic and sustained corruption?

KENNETH LIEBERTHAL: No.

GORDON WU: Difficult.

STAPLETON ROY: Professor Wang, you're permitted one word.

WANG SHAOGUANG: It is improving.

KENNETH LIEBERTHAL: By the way, I draw my answer because I live right outside of Detroit and have watched what has happened there.

STAPLETON ROY: Any more questions? Yes?

QUESTION: Shyh-Fang Liu, from The Brookings Institution, the Visiting Fellow from Taiwan. How do you predict that if there is any opposition, political party will be happened in China because the resolution of the fourth plenary says that stability and economic development are top priorities in China right now, but because many of you also emphasised that democracy in China is very important, but at the resolution of the fourth plenary they say, "Let's leave the democracy until the next generation." If one generation is 20 years, then after 20 years, what will happen to China if China is still controlled by only one Communist Party?

GORDON WU: Let me try to go to bat first. If you look at the Taiwan example, in the 1940s if you tried to start another political party, Chiang Kai-shek would have arrested you. In the 1950s and 1960s, still the same situation. Just ask Chen Shui-bian, he has been to jail as have many of the DDP members. So, do not try to start an opposition party in China in 2004 or 2005.

But, in due course, I am very optimistic that there will be such institutions, but you have to wait a bit of time. When the time comes, I think someday this will happen, but do not also underestimate the power of the Communist Party to make changes within themselves. They are not dumb people, and they will make the changes. Already I have seen lots of signs of very bright Communist Party members, the cadres that can do very good work in discharging the duties of the government.

Do not forget the Chinese are in a very difficult position in a lot of these places. Some of them, they are people who are caught in between. They do not have the prosperity of the coastal cities and they do not get the subsidies from the Central Government. But every city has got to have the incentive to try and

improve their lot and trying to improve their lot is the driving force and you do see some good people. Otherwise, how can a country, 25 years ago, who is on the verge of bankruptcy, and yet today, they became the largest buyer of Airbus and Boeing and all these things?

KENNETH LIEBERTHAL: As you know, there are village-level elections in China. Those do not involve political parties, but there is an electoral process. The current thinking is to extend electoral processes up a level or two so that within five years or so, I would not be surprised to see elections at the county level in China. Without political parties, where electoral activities are supervised by the current political apparatus, and there are multiple candidates for key positions in the electoral process that takes place. I think the current expectation at the top is that this will remain rigorously a one-party system for 15 or 20 years, and then, the next generation can make their own decisions on that.

That is related to a third issue that I hear about quite a bit and that is there is a real understanding that the Communist Party and the Government have to be able to identify the real issues that confront China and resolve those issues. There has got to be a good problem-solving apparatus that is different. China consists of a lot of different interests and they have to understand those different interests in order to understand and address and resolve the problems directly and effectively. If they do not do that, they fail dramatically.

But that is different from saying that the Chinese political system should represent the different interests in China through a formal mechanism. It should become a representative government. People should be able to make their interests known but it is up to the Communist Party to establish the agenda for the political system and to solve the problems that people have. The underlying belief -- and I have been told this by some of the people in charge there -- is that what people really want is not broad representation. What people want is particular solutions, concrete solutions to concrete problems. That is what they expect of the political system and that Westerners have it wrong when we always assume that people want representation. I am simply relating what I think the mindset is on addressing this issue.

STAPLETON ROY: We have run out of time. We have one last question back here if it is short.

QUESTION: It can be. Just one quick comment there and also one question. The comment on the capacity which everybody has been talking about, the capacity of the government, as you said, the ability to deal with issues and linking that to regional inequalities in terms of the capacity -- the quality of officials in different parts of the country.

I think you could throw that in, because if you go to a place like Dalian you can find the government full of people who have Master's degrees or MPPs

from Western countries and then you go to places like Xian and Wuhan and you probably cannot find very many.

The question I wanted to raise, and it is sort of funny for Hong Kong is: We have just had a panel on domestic politics and I never heard the word "faction." I never heard the words "elite conflict." Clearly, that may be partly because it is not quite there but somehow it seems very strange that we would have this entire discussion and not have one, just one comment or something about the Shanghai faction. What is going on there?

STAPLETON ROY: Is there a one-word answer to this?

KENNETH LIEBERTHAL: There is a one-sentence comment. You must have been trained at Michigan.

GORDON WU: The Communist Party thinking always has been negotiation and compromise in picking the cadres and what not. Yes, there are such things as factions and Li Peng became their premier because he was in Zhou Enlai's faction. He was the adopted son. All these sorts of things happen and one method is to accommodate the factions, keep the balance and keep the show on the road. Otherwise, if one faction is too dominant, then the other factions will not be happy. It might split the party.

STAPLETON ROY: Okay. Thank you very much. Could you join me in thanking our panelists.

(3.33 pm)

(Short adjournment)