Adaptive efficiency and pragmatic flexibility:
characteristics of institutional change in capitalism, Chinese-style

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1. Introduction

Since the breakdown of the communist world, capitalism has been considered as the unrivalled model of economy and society – a conviction deeply rooted (not only) in Western culture (Miller 2005). The late 1980s and early 1990s saw a widespread ascendancy of neo-liberal thought indicating that a singular world of market unification and institutional convergence was about to emerge. In the debates about policy reforms this development was reflected by the prominence of the so-called Washington Consensus.[1] But soon after this vision of a unitary and all-encompassing capitalism had been expressed, critics started to voice their concerns, pointing to "ostensibly resilient differences in the organization and trajectories of capitalist systems, regimes and models" (Peck and Theodore 2005: 1). It is noteworthy that differentiated patterns of institutional matrices underlying market exchanges have not only emerged in advanced market economies, but also in emerging and transition economies. Even more remarkable is the observation that China, the fastest growing economy over the past thirty years, managed to sustainably grow, effectively fight poverty, and sustainably address the challenge of structural change without substantial external support and against orthodox policy recommendation of mainstream economists and international organizations. Instead, the country pursued its *own* gradual and highly pragmatic approach. Moreover, the Chinese transition experience since 1978 has been an illustrative example that the state, i.e., central as well as regional political authorities, can and need to play a key role in transformative institutional change and innovation. State guidance and intervention interact with evolutionary bottom-up processes to bring about new institutional arrangements and a new market-oriented institutional environment.

This essay takes a *Northian* perspective and defines insitutions as the formal rules and informal constraints including their enforcement mechanisms which underlie economic and political exchange and shape human interaction. Institutions provide the incentive structure for the behavior of political, economic and other organizations. North (1990a, 1994, 2005) argues that economic change and development essentially depend on the *adaptive efficiency* of a country's institutional matrix, i.e. a society's dynamic capability and capacity to craft institutions which are productive, broadly accepted and fair, stable, and yet sufficiently flexible to adapt to new circumstances as a response to exogenous shocks or to growing tensions inherent to society's development. This paper aims at identifying the adaptively efficient features of China's institutional matrix which help to explain the economy's

[1] See Williamson (1990) regarding the rationale of the Washington Consensus. Critical discussions can be found, e.g., in Ahrens (2002) and in Rodrik (2006).

sustainable shift towards a higher trajectory of economic growth and development which not only benefits political elites or powerful factions, but the population as a whole.

The paper is structured as follows: Section 2 provides a brief overview of the Varieties-of-Capitalism (VoC) approach. This appears to be a useful starting point for two related reasons: (i) if there is neither a blueprint or best-practice approach to institution building nor a universal model of a market economy, we need to explicitly account for the diversity of institutional outcomes of economic reform and development; and (ii) if we seek to identify and to assess key features of institutional change in China, a differentiated framework for orientation is useful. Section 3 introduces the notion of *adaptive efficiency* which serves as a guide to the following analysis of the politico-institutional foundation of economic reform in China. In Section 4, key components of the Chinese institutional matrix since 1978 are identified which helped to make the economic development process adaptively efficient. Conclusions follow in Section 5.

2. Capitalist variations

Hall and Soskice (2001) claim that economic development and policies follow path-dependent trajectories and entail a set of manifold capitalist variations. But frequently, a country's institutional architecture tends to evolve either towards a liberal market economy (LME) or towards a coordinated market economy (CME). Both types are seen as extreme forms of political economies representing the two pure ends of a spectrum along which nations can be arrayed.

2.1 Varieties of capitalism

In LMEs, transactions are mainly organized through competitive markets and hierarchies. The preference for market-oriented institutions induces a typical pattern of corporate behavior: firms will invest in *switchable assets* such as general skills and multi-purpose technologies, because these do not tie up corporate resources in the long-run, but facilitate a short-run realization of value. Hence, companies will be more attentive to current earnings and to their share price on equity markets. Moreover, LMEs are characterized by deregulated labor markets and strong product-market competition. On the contrary, in CMEs, a much higher tendency to invest corporate resources into specific assets exists, the value of which cannot be realized rapidly. Instead, it is based on the availability of patient capital and the expectation of cooperative behavior of other actors (Peck and Theodore 2005). Hence, a longer-term orientation prevails, and coordination problems are primarily solved drawing on non-market relationships such as networks and centralized associations – the so-called strategic coordination. This preference for network-based approaches in one sphere (e.g., in the financial system) is likely to produce mutually reinforcing spillover effects in related institutional domains. Therefore, CME characteristics also include cooperative industrial relations, high levels of vocational training, weakened product-market competition and strong information exchanges through more or less formal professional associations favoring the establishment of common industrial standards (Amable 2003). LMEs and CMEs thus represent coherent configurations of complementary institutional elements. This helps stabilize the respective system, makes institutions self-enforcing and institutional change path-dependent (Miller 2005).

2.2 Institutional complementarity

Institutional complementarity exists if one (or more) institution(s) enhance(s) the effects of (an)other institution(s). If, e.g., the efficacy of labor market institutions depends on a specific type of institutions for corporate governance, then efforts to assess the impact of labor market rules that do not also consider the nature of corporate governance may generate misleading conclusions (Hall 2005). This interaction effect holds for most kinds of institutions. Crouch et al. (2005) point out that institutions are not always designed to be complementary – complementarity is often discovered at a later stage in time. This means that a high degree of experimentation is involved in the process of institution creation. The key lies in the perspective which regards political action as driven by the interests of individual actors, meaning that "politics is usually about who gets what, when, where and how" (Hall 2005: 376). As an actor-centered and rationalist approach, VoC theory conceptualizes the political economy as an environment populated with entrepreneurial actors seeking to advance their interests as they construe them and looking for ways to make institutions work for them.

The notion of complementarity implies that it is not possible for a capitalist regime to easily switch from one system to the other. Self-reinforcing differences imply diversity in forms of capitalism, which represent a so-called comparative institutional advantage of nations: LMEs exhibit different patterns of innovation and technological change as well as a different industrial specialization compared to their CME counterparts. LMEs have a comparative advantage in industries where competitiveness is based on a firm's ability to quickly adapt to changing market conditions. Radical innovation patterns prevail. CMEs, on the other hand, have their competitive advantage in industries where success is based on building up cumulative knowledge and company-specific skills. Incremental innovation prevails in this system (Miller 2005).

3. Institutional change and adaptive efficiency in a political economy

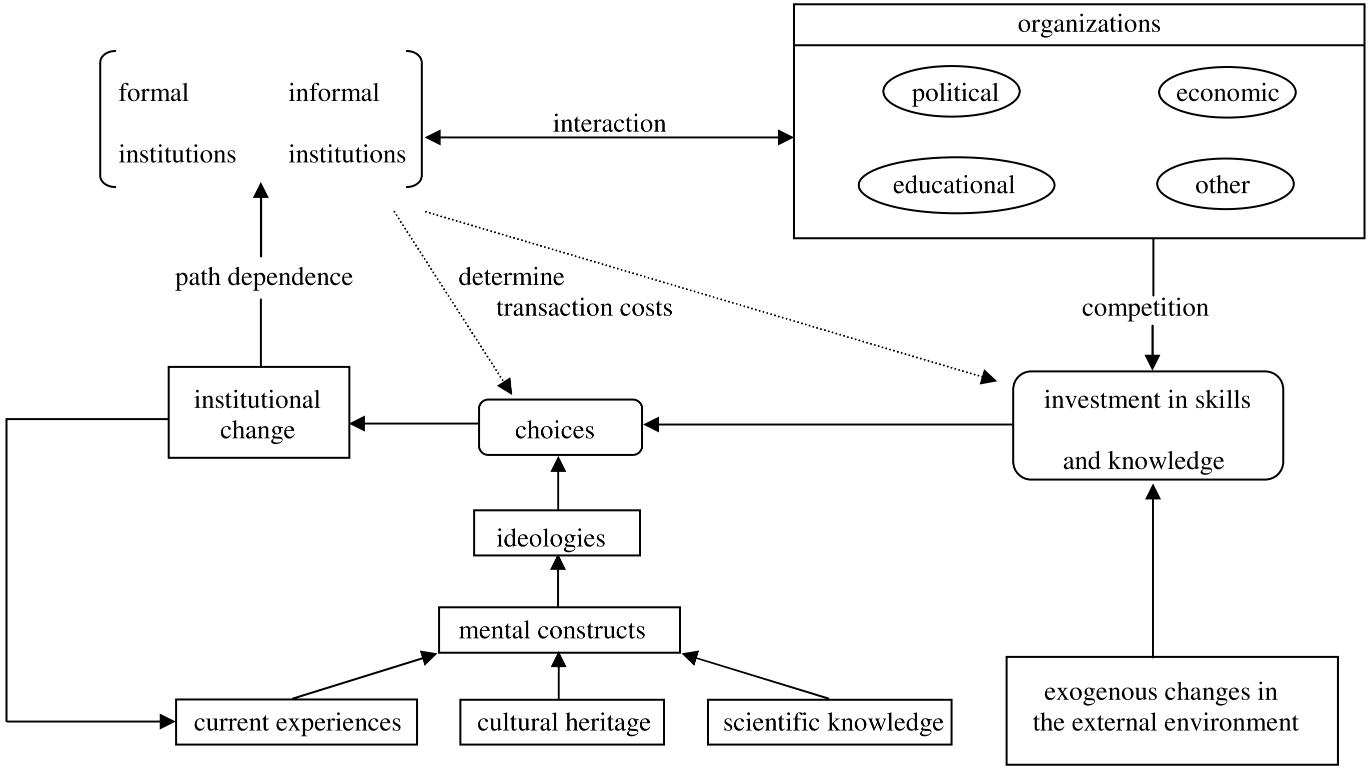
While the VoC approach analyzes the institutional pillars of different market systems, allows to classify market orders, and explains the existence of institutional complementarities and comparative institutional advantages, it does neither analyze the way towards such a distinct market order nor does it identify the conditions under which different sets of economic institutions are emerging. The following considerations take up these challenges and argue that it is specific characteristics of an institutional matrix which enhance the adaptive efficiency of an economy.

Particularly, North's theory of institutional change, which seeks to integrate the model of induced institutional change, the pillars of collective action theory and the role of informal institutions, has greatly enhanced our understanding of historical and contemporary institutional change.[2] Since it explicitly models the interdependencies between the economic, political, and socio-cultural suborders of society, the *Northian* approach goes beyond the realms of traditional institutional analyses. Therefore, it is particularly useful for exploring the critical determinants of economic performance through time and the still puzzling questions concerning the politico-institutional foundations of economic reforms. The following discussion synthesizes the essential pillars of North's model of institutional change in general and the importance of political institutions therein in particular (see Figure 1).

North (1990a) explains the development of, and change in, institutional arrangements through a complex interdependent process among organizations and between them and formal and informal institutions. He explicitly rejects the postulate that only the most efficient institutions will survive over time. On the contrary, institutions may, and in fact do, yield transaction cost-increasing effects and often lead to economic stagnation and even decline.

According to North and his followers, the institutional and organizational structure of a society is the key variable to understanding economic growth and development. While the institutional matrix, i.e. the whole of a society's institutions, defines (together with the traditional constraints of economic theory) the opportunity set available to individual choices, it is individual entrepreneurs (political and economic) and organizations that are the agents of institutional change. The interest groups and organizations of a society evolve as a consequence of the opportunities and hence incentives that are provided by the institutional matrix. Organizations are purposeful entities composed of individuals who act collectively in pursuit of shared objectives (to maximize profits and welfare, to extend power; but ultimately to survive). North (1995a and b) states five propositions which explain institutional change:

[2] The following paragraphs are essentially drawn from Ahrens (2002).



Source: Ahrens (2002)

Figure 1: A stylized Northian model of institutional change

1. The existence of scarcity and competition is the starting point to explain institutional change (see Figure 1). This setting implies a continuous interaction among organizations and between them and institutions.
2. This endogenous competition as well as exogenous changes such as changes in relative prices or technologies force organizations constantly to acquire new knowledge and skills that are necessary to survive and to achieve immediate objectives. The investment in skills as well as knowledge, in turn, shapes the evolving perceptions of individuals and organizations about present opportunities and choices which will incrementally, though steadily, modify or replace existing institutions by new ones.
3. Since the existing institutional matrix determines the costs of transacting and provides the overall incentive structure, it not only constrains actual choices, but consequently determines the kind of learning that actors perceive to have the highest payoff. This implies that (induced) institutional change will not necessarily be efficient in the sense that more productive, growth-enhancing arrangements will evolve. Since every institutional matrix provides mixed incentives favoring both redistributive and productive activities, the performance of an economy will depend on the relative weights attached to each category. If actors perceive that redistributive activities have the highest returns, organizations are expected to invest in rent-seeking and similar activities. If, however, the maximum payoffs are perceived to result from productive activity, organizations will seek to acquire knowledge and skills that help to increase productivity.[3]
4. The perceptions of individuals and organizational actors, which eventually shape their choices, are essentially influenced by what North (1995a: 7 and 9) calls “the mental constructs of the players”, that is “the way the mind interprets the information it receives”. These constructs result from genetic evolution, cultural heritage, progress in scientific knowledge, and current experiences such as local learning (Denzau and North 1994; North 1994b). This implies that – given the same facts – the choices of different individuals may be based on different interpretations of the evidence and different perceptions about how the world around them is and how the world ought to be. Hence different subjective ideologies may lead to different actions. Although ideologies economize on transaction costs and facilitate information processing, a sufficient correction of individual perceptions which would imply convergence towards a single equilibrium can hardly be expected. Due to bounded rationality, individuals will lack a complete information feedback regarding the consequences of their choices. Thus, because of different actions of individuals having the same preferences, multiple equilibria can ensue (North 1992).
5. Institutional change is incremental and subject to path dependence in ideas, ideologies, and institutions. Hence economies cannot reverse their development direction overnight. This is due to the network externalities, economies of scope, and complementarities that are

3 See North (1990b). Note, in this context, that a society’s investment in formal education as well as basic and applied research may possibly be an even more essential determinant of the future development direction of its economy. This kind of investment will basically reflect the perceptions of political decision makers.

inherent in the institutional matrix. Organizations that exist in a particular society, their internal structure and relations as well as their complex contractual and other relations with other organizational entities in the economy and the polity have been built on the given institutional matrix. Therefore, organizations tend to have an interest in maintaining (most of the elements of) that matrix. Furthermore, the outcomes of current learning processes, which have induced the present institutions, constrain future choices. As organizations evolve over time to capture potential returns more effectively, they will gradually seek to alter the existing institutional constraints; either indirectly through the interaction of organizational behavior and its impact on changing informal rules; or by seeking to alter formal institutions directly. "In either case", as North (1989: 667) argues vividly

> the change is an incremental process; the result of thousands of individual decisions by organizations and their entrepreneurs which cumulatively are altering the institutional framework over time. Thus short-run profitable opportunities cumulatively create the long-run path of change. The long-run consequences are often unintended for two reasons. First, the entrepreneurs are seldom interested in the larger (and external to them) consequences but the direction of their investment influences the extent to which there is investment in adding to or disseminating the stock of knowledge, encouraging or discouraging factor mobility, etc. Second, there frequently is a significant difference between intended outcomes and actual outcomes. Outcomes frequently diverge from intentions because of the limited capabilities of individuals and the complexity of the problems to be solved.

More radical institutional change may only occur if organizations pursuing different interests come into being and if the emerging inter-organizational conflicts cannot be overcome within the given institutional framework.

The characteristics of institutional change just described do not reveal whether or not this change will be efficient. If we are concerned with the dynamic implications of the interaction among organizations and the interdependencies between organizations and institutions for economic performance, we need to go beyond the static concept of allocative efficiency that presupposes a given institutional framework. Therefore, North introduces the concept of *adaptive efficiency*.[4] This concept rests on the assumption that a sufficiently flexible institutional framework, that will provide low transaction costs, facilitate credible commitment, suitably adapt to a changing demographic, technological, and political environment and smoothly absorb exogenous shocks, is a *conditio sine qua non* for the emergence of efficient markets and sustained economic performance. More specifically, a dynamic economic evolution, that results from systematic and continuing investments in learning and the application of the new skills and knowledge to economic and political exchanges, needs to entail specific institutional characteristics if the society is to be shifted onto a higher trajectory of development. These properties, similar to technology development, concern a society's willingness and ability to acquire skills and knowledge in productivity-enhancing activities, to foster innovation, to undertake creative activities, and to take risks. They also concern societal characteristics of overcoming current bottlenecks and problems, e.g., relating to policy reforms, as they arise and yet to provide secure political and economic

[4] See North (1990a, 1992, 1995a, and 2005) and Pelikan (1985 and 1987) for further elaboration.

rights. While North (1990a and 2005) concedes that social science research is far from having elaborated all criteria that ensure adaptive efficiency, he persuasively argues that the institutional matrix is the key that determines the degree to which innovations, trials, and experiments will be encouraged in a given society. For it is the incentives resulting from the overall institutional structure that guide learning processes and the emergence of tacit knowledge. The underlying process of acquiring knowledge will direct individuals and organizations gradually to create new institutional arrangements.

Similarly, Eggertsson (1998b) argues that due to bounded rationality as well as incomplete private and public policy models, institutional change is often continuous and incremental. Both the private and the public sector seek to understand and estimate the interdependencies as well as the relevant properties of the societal subsystems. Private agents, e.g., seek to identify new margins of business operations; either to find ways of making their productive activities more profitable; or to soften the constraints to their businesses. Government agencies attempt to constrain private actors more effectively by improving their understanding with respect to the relations between policy instruments and targets. All actors gradually revise and update their economic models and accordingly reinterpret the need for, and implications of, institutional rules, constraints, and enforcement mechanisms. Then through the interactions of private and public actors, institutional arrangements change over time. As Eggertsson (1998b: 27) concludes: "The direction of change can be toward collectively rational outcomes or toward collectively irrational outcomes, and the direction may not be fully understood until relatively late in the game."

It follows from the preceding arguments that an institutional matrix will be adaptively efficient, yield collectively rational outcomes, and be suitable to resolve conflicts and problems over time, if it

(1) provides individual actors and organizations with incentives to pursue various trial-and-error searches for conducting activities and hence permits a large number of choices to be made under uncertainty;
(2) ensures competition, protects well-specified property rights, and enforces bankruptcy laws;
(3) encourages the emergence of decentralized decision-making mechanisms; and
(4) ensures feedback effects with respect to identifying relatively inefficient prior actions.

Opportunities for trials and experiments as well as decentralization will enhance the creation of tacit knowledge, encourage the exploration of a great variety of alternatives in order to solve problems of scarcity, and eventually help to bring about institutional complementarities. This, however, presupposes the existence of entrepreneurship (for the initiation of trials) and competition (for the elimination of errors). Feedback mechanisms help actors to learn from failures and to correct organizational errors and policy makers to enhance policy adaptability (Pelikan 1987).

While individual economic and political entrepreneurs and organizations are the agents of institutional change, their bargaining strength and the distributional effects of institutional arrangements are of utmost importance regarding the question of whether or not a society will realize an adaptively efficient path of development. In reality unproductive paths can, and in fact often do, persist. Since the institutional matrices of all economies and polities provide actors with varying incentives to pursue unproductive as well as productive activities, historical performance records of societies usually reflect mixed results. Moreover, the same fundamental changes, e.g., institutional innovations (imposed from outside actors like international organizations) or changes in relative prices, will affect economies differently. While in each economy marginal adjustments will occur, the ensuing changes will reflect the interests and the bargaining power of different actors who have come into existence under different country-specific institutional frameworks. Because of the different institutional matrices, the bargaining power of parties affected by these fundamental changes will also differ. In addition, marginal adaptations to changes will reflect the different ideologies that actors developed in countries with different histories. In sum, this implies that actors in different countries will make different choices even if they are confronted with the same (exogenous) changes.

The preceding argument highlights why efficient institutional change is an extremely complex process. The creation of adaptively efficient economic and political markets cannot be solely achieved by formal institution building. Formal institutions must complement informal constraints and effective mechanisms of enforcement in order to bring about an internally consistent and coherent overall institutional framework (North 1992; Eggertsson 1998a). Informal institutions such as conventions, codes of behavior, and self-imposed standards of conduct, however, change slowly. Furthermore, at least to some degree enforcement of new institutions will have to rely on the power of those interest groups and organizations that may have a vital interest in maintaining the old rules of the game. Finally, institutional change may be a substantial source of conflict, because in its course old dominant organizations will be replaced by new ones. If in a particular economy the existence of unproductive opportunities dominates economic and political exchange, how can the emerging, possibly inefficient, development path be reversed? How can economies and polities enhance their capacities and capabilities to form and maintain a well-performing mixture of both types of incentives? Due to the complexity of overall institutional change, simply transferring the formal institutional framework of successful economies to reforming ones will not automatically yield desirable results. As the rush to establish market-oriented economies in less developed countries and transition economies indicates, outcomes vary considerably: from Poland and China, which have been success cases so far, to Russia and other successor states of the former Soviet Union, which have shown only limited progress so far – to the countries of sub-Saharan Africa, many of which remain hopeless cases.

In summary, economic growth is contingent on the existence of *stable but adjustable* political and economic institutions which provide low transaction costs in impersonal economic and political markets. However, institutional arrangements can neither be taken for granted nor do they come automatically into existence from neoclassical policies aimed at privatization and getting the prices right. By emphasizing that most economic rules are, and need to be, made in the polity, North (1990a, 2005) stresses that institutional change is largely dependent on the power structure or balance among vested interest groups in a society. Although he does not neglect the impact of changes in relative prices and preferences, institutions essentially reflect the relative bargaining strength of political factions, individual policy makers, trade unions, business associations, and other vested interests in the political market. Major changes in formal institutions will only occur if these changes are in the interest of those parties that have sufficient bargaining strength. Therefore, a critical component of policy reform is to encourage the emergence of organizations that support economic and political institutions that are conducive to market development. Moreover, since informal rules help to enforce formal institutions and legitimize a new set of formal rules, it is necessary to change both the formal and informal institutions in order to induce a coherent institutional matrix. But changing informal institutions is time-consuming, so that successful policy reform can usually only be achieved through a lengthy process.[5]

4. The Chinese path towards capitalism: enhancing adaptive efficiency through transitional institutions

Chinese transition has been taking place without political democratization. Not having had to cope with an economic and political transformation at the same time, it is usually argued that China has escaped the dilemma of simultaneousness. But even in China, as an impetus to and a consequence of economic transition, a gradual, though far-reaching change of institutions has taken place – a market-induced transformation of the Leninist state (Heilmann 1998) and hence the emergence of a post-socialist transition order. This change entailed substantial alterations of the country's governance structure.

So far, two major phases of economic transition can be distinguished: The first phase (1978-1993) was characterized by gradual reforms which aimed to realize efficiency gains through reforms of the planned economy. The second phase started with the decision of the Third Plenum of the 14th Party Congress in September 1993 to transform China's economy into a *socialist market economy*. Since then building market institutions and creating a rule-based market economy have become key objectives of transition policymaking (Qian 1999).

[5] Note that informal institutions are clearly not a policy variable. They can, at best, be changed indirectly, for example, through investments in a country's educational system or progress in social science research.

4.1 Political feasibility and legitimacy

From the perspective of Chinese authorities, policy reform and institution building had to yield material benefits for large parts of the population. Even more important than in other so-called developmental states, economic growth and modernization were conceived as the foundation of political power, that gave legitimacy for, and support of, the political monopoly of the CCP and its societal leadership. Through the implementation of comprehensive economic reforms, "China's politicized capitalism has evolved a strategy of transition aimed at balancing the interest of reformers to safeguard the power and privileges of the political elite even while instituting reforms that both reduce the scope of state managerial controls over production and distribution and expand the role of the market as a mechanism to motivate and guide economic growth" (Nee and Opper 2006: 3).

Hussain et al. (2000) and Qian (2003) convincingly argued that unorthodox *transitional institutions* turned out to be more effective than presumably best-practice institutional arrangements in a period of economic transition. Especially in China's authoritarian regime, they made market-oriented reforms a viable policy choice, because they helped political authorities maintain power and control and, additionally, opened up ways to make political elites winners of reform. Finally, specific transitional institutions tailored to society's needs, capacities, and capabilities could be much faster developed than best-practice institutions – the latter usually need a long period of time to be crafted and enforced, and in an underdeveloped autocratic transition economies, there would be a lack of human capital to operate them. In China, new transitional institutions took advantage of the existing social capital and helped to preserve basic practices and codes of behavior. Evidence shows that transitional institutions served as functional equivalents to first-best institutions, e.g., with respect to creating incentives for doing business, to introduce competition, or to establish control rights over the means of production.

4.2 Adaptively efficient! Transitional institutions and emerging institutional complementarities

During the first phase of economic transition, reform-minded political authorities developed and maintained their capacity to foster policy and institutional measures promoting market exchange despite increasing corruption and cleavages within the Chinese Communist Party (CCP). In the course of time, the central government managed to credibly limit its own power through decentralization, anonymous banking, and increasing openness vis-à-vis other economies. In this context, the incentive compatibility of policymakers at the national and the subnational levels has been of particular importance.

4.2.1 Enhancing adaptive efficiency through institutional innovation

In the absence of the rule of law and private property rights, economic growth could be propelled via increasing competition and distinct *transitional institutions* which proved viable in this particular environment. These institutions were not influenced by theoretical models, but relied rather on innovation and experimentation resulting from and reinforcing the adaptive efficiency of the country's institutional matrix (Qian 1999).

Household responsibility system and dual-track-approach

An important step in the early phase of transition was the gradual reform of the agricultural sector through the introduction of the household responsibility system (i.e., a shift from collective to individual production and ownership) and a partial liberalization of certain goods markets. This helped to restore economic incentives, to yield quickly substantial productivity gains, and to develop a nascent, but increasingly flourishing private sector at a time when restructuring of the state sector was off limits especially for ideological reasons. It also increased confidence in market forces and strengthened the support of further reforms at later stages (Lee 1997). Regarding industrial restucturing, China adopted a dual-track approach which allowed to maintain parts of the planned economy for a transition period, until a possibly emerging private sector would have gained sufficient economic strength so that it can absorb surplus labor from heavy industry (Qian 2003). This approach helped to enhance economic efficiency of state-owned enterprises (SOEs), to minimize opposition to economic reforms *ex ante* (due to temporarily protected status-quo rents) and to increase the opposition to reform reversal *ex post* (due to an increasing number of people benefiting from reforms) (Lau et al. 2000). This approach was clearly compatible with a prevailing, potentially market-skeptical political ideology, and it was consistent with a gradual strategy of opening up vis-à-vis the rest of the world.

The household responsibility system and the dual-track approach to industry shifted the focus away from distributional activities and provided incentives for myriads of Chinese to engage in productive activities. They encouraged the acquisition of new how-to-do-business knowledge and learning how market processes work. As a response, numerous small economic actors emerged as dynamic economic entrepreneurs who (in concert) could exert effective influence on market-oriented institution building. The whole of their economic choices mattered and eventually helped to alter the perceived reality of political entrepreneurs. Finally, these transitional institutions served as feedback mechanisms: They provided means to deal with uncertainty and to engage in experiments without generating potential losers from reform. These opportunities for experiments, in turn, facilitated the emergence of institutional complementarities which enhanced the overall efficiency of the economy.

Decentralization, hard budget constraints, and competition

Competition on domestic markets was further strengthened and the power of the central government limited through decentralization and the emergence of a so-called system of market-preserving federalism (MPF), Chinese-style (Montinola et al. 1995). This system provided regional and local governments with relatively hard budget constraints, but also with incentives and means to conduct their own economic policies and to claim the residuals of so-called Township-Village Enterprises (TVEs), while the central government sought to hinder subnational governments to erect trade barriers and to preserve the common market.

Moreover, decision-making over market entry had been decentralized. This gave a considerable impetus to sub-central governments to foster the emergence of new collectively-owned and rural companies, the transactions of which were market-based, with output planning fading away. Jurisdictional autonomy in a system of MPF made territorial governments behave as entrepreneurs searching investment opportunities, taking risks, and providing capital at a time when risk markets had been largely underdeveloped (Hussain et al. 2000).

In the 1990s, when genuine private companies still played an insignificant role, TVEs contributed substantially to economic growth. Local governments were capable of protecting TVEs against ideologically motivated anti-private-property programs[6], and it was easier for TVEs to receive bank credits.[7] As TVEs were publicly owned, managers could be monitored and sanctioned by the local government, thus reducing principal-agent problems. But a major precondition for the emergence and success of TVEs was decentralization leading to market-preserving federalism. This system provided local governments with authority over local economic development and gave them the right to retain most of the local tax revenues.[8] But as the ideology against private property rights became less restrictive over time, the advantages of local government ownership were reduced. Consequently, local governments transformed more and more TVEs into individual shareholdings (Che 2002).

Decentralization provided incentives and opportunities for experimentation and economic change without triggering major dislocation (Hussain et al. 2000). Thus, decentralized decision-making units facilitated the quest for development enhancing institutions and solutions to problems of transition and underdevelopment (which differed

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6 Che and Qian (1998a and b) argue that local governments were less likely to be expropriated than private owners as the local government used TVE rents for improving the provision of local goods. Thus, the interests between central and local governments were better aligned than the interests between the central government and private owners.

7 First, banks were exposed to less risk when lending to TVEs as the local government could bear some of the banks' risk due to cross-subsidization among its various TVEs. In addition, the fact that the local government protected the TVE's property reduced default risk. Second, local governments capitalized on their personal relationships to state-owned bank managers; see Qian (1999a).

8 Qian (1999a) argues that the local government founded their own business rather than taxed private businesses as it was cheaper to extract rents from the own business. Following the same argument, the central government faced difficulties to take away proceeds from TVEs; in addition, Krug and Hendrischke (2004) argue that a high amount of social capital might have facilitated the emergence of entrepreneurship in China in the absence of secure property rights.

across regions). To some degree, MPF in combination with TVEs served as functional equivalent to (weak) private property rights and the missing privatization of SOEs. Competition among TVEs, between them and other companies, and between different jurisdictions fostered the emergence of market-oriented business practices, facilitated market exchange, and yielded efficiency gains in different branches of industry.

External opening up and competition

Another key characteristic of the Chinese transition process has been the gradual opening up of the economy. This did not only relate to foreign trade flows, but also to the attraction of foreign direct investment (FDI) in special economic zones (SEZs), which were considered as a core component of the overall approach to economic reform already in the late 1970s (Nee and Opper 2006). FDI implied an infusion of new capital, technology, and skills into parts of the Chinese economy without exposing the whole economy to international competition from the very beginning. Particular incentive schemes helped to gradually shift FDI from labor-intensive manufacturing towards knowledge and capital intensive technologies. In addition, local content rules ensured that Chinese companies benefited from increasing FDI inflows. Eventually, local content rules also related to R&D activities, so that local enterprises could deepen their technological exchange with foreign companies (Nee and Opper 2006).

SEZs represented a transitional institution in the sense that a free-trade area or a customs union with third countries may have appeared to be more efficient from a theoretical viewpoint. Since, however, these options were politically not feasible, SEZs served as a feasible way to open up the economy and, in addition, signal the government's commitment to market-oriented reform. This was reinforced, e.g., through public infrastructure investment, low tax rates, and liberal institutions and market rules governing SEZs (Khan 2002). Eventually, SEZs proved to be an appropriate institutional innovation which allowed for economic and institutional experimentation, yet helped authorities to maintain control over the economy and provided them with feedback on the efficacy of public policy measures.

Finally, the gradual opening up of the Chinese economy, increasing its exposure to foreign competition and membership in international organizations helped to incrementally and credibly enhance reform commitment. Particularly WTO accession confirmed the government's commitment to gradually invigorate the rule of law as an additional limiting factor to its power. Moving closer to a rule-based economy, economic institutions have been more consistently enforced during the second period of transition (particularly through the privatization of SOEs and the restructuring of the financial sector). This helped to enhance authorities' credibility and reliability from the viewpoint of economic actors including foreign investors, governments, and international organizations (Ahrens and Mengeringhaus 2006).

Stock-market development

China has performed better than most other transition countries when standard measures for stock market performance are analyzed, even though the country has only slowly developed a legal framework for stock markets and shows a weak law enforcement record (Pistor and Xu 2005). Given this seeming contradiction, there must have been other governance institutions that served as a substitute for the lack of formal law (enforcement) and that were thus complementary to the wider institutional transition context in which the stock market has been embedded. Initially, China had primarily relied on an administrative governance system built around a quota system that relied on the decentralized structure of the Chinese administration (Qian and Xu 1993). This system served two important functions: It helped mitigate serious information problems that investors and regulators faced in China, and it helped local bureaucrats to select viable companies at the IPO stage. Quotas had been the basic feature of economic management and regulation in China before and during the transition period. The system was designed to allocate critical resources across regions, such as credits or energy (Pistor and Xu 2005). The annual quota for a region, i.e. the amount of shares firms were allowed to issue to the public, was set in an intense bargaining process between central and regional authorities. The primary purpose of the central government to adapt the quota system to the stock market was to gain and maintain control over its size and stability. In practical application, however, it went far beyond that: Due to regional competition, it fostered a selection and information collection process that facilitated market development during the start-up period, because the quotas were set by the central authority drawing on the quality of the companies selected and handed in for assessment by regional governments. Regions, which performed well, were rewarded by the China Securities Regulatory Commission (CSRC) and those whose companies failed or underperformed were punished. Regions thus had an incentive to collect and reveal critical information about the real quality of companies in their area. Based on their assessment, the CSRC pre-selected companies that were allowed to enter the formal approval process. The quota system has significantly raised disclosure levels and transparency – critical factors for a functioning stock market. Of course, the system with its inherent institutions has not been built for the long-run, but must be seen as a transitional institution. Today, China has already started to abandon the system and to "grow out of" the quota system.[9] China is now strengthening its legal infrastructure and enforcement mechanisms (Lu and Yao 2003). One major area of concern, however, is the reliability of firm-specific information as intermediaries capable of verifying information have only begun to emerge. Chinese financial reporting, accounting practices and disclosure are currently oriented to primarily meet the information requirements of taxation authorities and not those of investors (Tenev et al. 2002). A separate reporting for tax and accounting purposes does

[9] See Naughton (1996), who describes China's economic reform process as an approach of "growing out of the plan". The quota system serves as one example for the pattern of Chinese reform in general. It was put in place in 1993 and officially abandoned in 2000.

not exist. The consequence is that tax laws determine how accounting is carried out in China. This system therefore paradoxically constitutes a high incentive for Chinese companies to use loopholes in the system and to modify information (Bai et al. 2004). This shows that the Chinese accounting practices are still far away to fulfill the qualitative characteristics of good corporate accounting as formulated by the Financial Accounting Standards Board (FASB).

Corporate governance in transition: an area of experimentation

Judicial systems, capital markets, institutional investors are hardly developed. However, given the vast differences in ownership structures, business practices and enforcement capabilities, merely adopting seemingly best-practice rules and regulations from abroad would be a mistake (Barton et al. 2004). But continued opening up of markets to competition is essential to reduce the incentives for (state) ownership concentration and therefore to increase the incentives for dispersed shareholding, risk diversification at the level of individual or institutional wealth holders, and hence for improved governance practice. Given the size of the country and the different institutional constraints that have evolved over time, reforming corporate governance should not follow a single model but allow for diversity. "In this sense, the most dangerous reform strategy is to insist on a single organizational model for all enterprises in the country" (Qian 1995: 252). Today's situation shows an ambiguous picture that is highly inconsistent with the VoC concept. German-style coordinated components have been identified as well as liberal elements: The banking system is comparable to the main-bank system in Japan and therefore close to a CME concept (Aoki 2001). However, the monitoring capability of Chinese banks is still low. Other institutions such as the general meeting of shareholders, i.e. the 'organ of power', also face a problem of ambiguity because codified law often differs substantially from legal practice. The fact that large shareholders dominate, relationships matter, and an absence of dispersed ownership structures are strong indicators for a CME environment. The same holds for the board of supervisors that draws on the German model. On the other hand, China's regulatory structures are based on the Anglo-American corporate governance system. This fact serves as a strong indicator that China is oriented towards a LME concept.

To summarize, it can be said that with a stock market still in its infancy and an inefficient banking sector and a very ambiguous picture in the domain of corporate governance, the Chinese financial system can hardly be categorized within the VoC framework. China seems to follow neither a pure shareholder nor a pure stakeholder approach. While this configuration can be efficient during the transition process, it could disappear as the economy matures.

Labor markets in transition: path dependence prevails

In the pre-reform era, government controlled the job market, job changes were usually prohibited, but workers usually enjoyed life-long employment. Since 1978 deregulation helped to liberalize the labor market. But the state administration continues interventions and slows down efficiency gains. Managing labor-market transition is one of the most challenging tasks for the government; not least because increasing unemployment could undermine authorities' legitimacy.

The first wave of liberalization had taken place in the goods markets before the labor market was addressed in China's urban areas (Hope and Lau 2004). Labor allocation used to be steered by labor bureaux: Job eligibility was restricted to residents in possession of a *hukou* (i.e., a local residence permit), which entitled them to housing, food subsidies, schooling as well as retirement and health benefits. Wages were centrally determined. A formal wage grid mainly valued formal qualification such as education and years of experience and largely ignored an individual's actual labor productivity. These institutional arrangements imposed severe limitations on job mobility and flexibility and led to inefficient solutions.

A turning point in the reform process was the introduction of labor contracts in 1986. This system implied that enterprises were only responsible to workers for as long as the contract specified and were no longer required to continue to pay workers a salary after the contract had expired. The new Enterprise Law stated that "the enterprise shall have the right to employ or dismiss its staff members and workers in accordance with the provisions of the State Council" (Guthrie 1999: 88). This institution marked a radical shift in China's reform history. Other institutional changes complemented this step, such as the introduction of unemployment and social security funds. By 1995, 93% of all SOE employees were under contract (Meng 2000). The labor contract system brought about a relatively flexible labor-allocation mechanism. Yet, severe restrictions, e.g., remained in regional mobility and, although management had gotten more control over recruitment, it was still bound to state labor plans and could not dismiss employees due to overstaffing until the early 1990s (ibid.). Today, regulations are more relaxed, but liberal hiring and firing has nevertheless not become common practice. Another factor preventing further liberalization can be found in the belief systems of Chinese managers: Often, they choose not to dismiss employees due to their conviction that the company is a kind of *socio-political community*. Managers are responsible for that community and are judged by both their superiors and their subordinates on their success in all areas regarding community welfare, including employment (Guthrie 1999).

Managing uncertainty: guanxi and inter-firm relations

Guanxi (i.e., 'relationship' or 'connection') is a cultural characteristic that has powerful consequences for inter-personal and inter-organizational dynamics in Chinese society. Having emerged over many centuries, *Guanxi* is embedded in every aspect of personal and organizational interactions. It has its origins in Confucianism which fosters collectivism, the importance of networks and inter-personal relationships. It represents a form of social capital, because it involves the exchange of social obligations. This reciprocal exchange of favors is essential to grow and sustain *guanxi*. "The rules of reciprocity in guanxi establish a structural constraint that curtails self-seeking opportunism and preserves social capital within the existing network structure" (Park and Luo 2001: 457). *Guanxi* has remained a critical factor in company performance in today's China. It structures the pattern how a firm interacts with its environment and therefore has a direct influence on the flow of resources. *Guanxi* has become even more important in the context of managing the increasing uncertainty in the course of reform. Chinese firms utilize *guanxi* to manage organizational interdependence and to deal with institutional disadvantages and other structural weaknesses. Its effectiveness depends on its fit with institutional and organizational attributes (ibid.). As China's transition process has led to increased institutional uncertainty, firms turn closer to *guanxi* networks to lower their external dependence on resources and to lower bureaucratic costs that would arise from internalizing operations. As a loosely structured network, *guanxi* is an adaptively efficient means to facilitate economic exchange. Guanxi-based *network capitalism* stretches out to a multitude of (small-scale) actors and does not tend to expand into large bureaucratic structures that would come about in traditional CMEs. To overcome disadvantages from small size, Chinese businesses band together into clusters which are linked through flexible horizontal networks. The *guanxi* structure is also quite open to new members, as opposed to company networks, e.g., in Germany. In western countries, a relationship between business partners usually arises after the transaction whereas in China transactions often follow successful *guanxi*. A major concern of Chinese organizations is to engage in extensive networking activities through *guanxi* to build trust and exchange favors (Park and Luo 2001).

In China's transition economy with ambiguous property rights and weak competition policies, *guanxi* provides an opportunity to increase market share through improved competitive positioning by collaborating with competitors and government authorities. Firms establish *guanxi* networks to overcome strategic and institutional weaknesses by linking up with those agents with whom they are only remotely related, but which control key resources (Park and Luo 2001). In sum, China exhibits a distinct prevalence of *guanxi*-networks in the private sector. Capitalist development is therefore characterized by a duality: On the one hand, a large state sector operates in key industries and services and stands under the control of the central government's industrial policies. On the other hand, this state sector coexists and melds with a private sector that is structured by *guanxi*-networks. *Guanxi* as a set of informal institutions deeply influences and coordinates economic activity, reduces business uncertainties and helps overcome deficiencies of formal institutions.

4.2.2 Institutional complementarities

The sustainable success of China's gradual reform indicates that the dynamic set of transitional institutions has been relatively efficient. However, this does not imply that the current institutional configuration is stable. Possibly, it will transform into a different one as the economy matures. However, institutional change has been (and certainly remains) incremental and path dependent bringing about important institutional complementarities. In the Chinese case, these complementarities have been often productivity- and development-enhancing as several examples may illustrate:

Given the problems in the legal domain, the financial system has produced striking characteristics: The quota system applied to the stock-market has raised transparency and disclosure levels significantly. A positive-selection of qualitative companies was induced which led to a performing stock-market. The quota system has thus raised the efficiency of the stock market – both institutions appear to complement one another. Weak competition policies and ambiguous property rights – another set of institutions that exhibits major deficiencies if analyzed from an 'advanced capitalism' perspective – are met by a sophisticated 'social software': *guanxi*. By collaborating in densely knit networks, e.g., with competitors and government authorities, a firm improves its competitive positioning and overcomes institutional weaknesses. The fact that R&D is carried out by research organizations or by individual companies that might cooperate with a small number of research institutes and hence do not create combined inter-firm and inter-industry research networks is in line with the VoC assumptions, given the focus on general knowledge as compared to industry-specific skills in the education and vocational training sector. Non-market coordination in industrial relations gives rise to non market coordination in both inter-firm and intra-firm relations. China has found effective non-standard institutions to support its growth.[10] The degree of complementarity can be seen as high though and serves as a reference point to explain the country's economic success.

Another example relates to the two-track approach: Nee and Opper (2006) emphasize that China's politicized capitalism entails a specific incentive compatibility through the dual-track mechanism: Government officials prefer to maintain control rights at the company level, and SOE managers strive to keep their access to public resources in an increasingly insecure and changing business world. But maintaining state-ownership of enterprises and subsidizing SOEs through soft-budget constraints within a government-led banking sector implied a massive increase in non-performing loans. So far, however, this has not become a major fiscal burden for the central government, but rather ensured the survival of SOEs, kept unemployment relatively low and compensated for the lack of a sound social-safety net. At the same time, the duality of the approach encouraged off-plan transactions in SOEs which were often intermediated through autonomous lower governments. Within some fifteen years after having introduced the dual-track system, the plan component has almost vanished (Hussain et el. 2000).

5. Conclusion

In some strands of the literature on policy reform and economic development, a "liberal-market consensus" (Khan 2002) appears to suggest that a distinct set of core institutions can

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10 See, e.g, Allen et al. (2002, 2005a and b) and Pomeranz (2000).

be identified which spur economic growth and sustained development.[11] According to this view, key institutions, which should be crafted as quickly as possible, include, among others, the rule of law, private property rights, an independent judiciary enforcing private contracts impartially, thorough regulation to safeguard economic competition, sound corporate governance structures and a transparent financial architecture, undistorted markets characterized by low rents, social insurance, democratic accountability and participation rules, checks and balances, and strengthening civil society (Khan 2002, Bardhan 2005).

Possibly, these Western-style best-practice institutions may represent a reference point for less developed countries and transition economies. However, experts advising governments on institution building have often neglected the *processes* of how these institutions are crafted and enforced. Frequently, a country's initial conditions are ignored and policy advice is driven by the presumed desirable goal of transition (i.e., Western-style best-practice institutions), and not by the search for a *politically feasible* path towards that goal (Qian 2003). In particular, it is hardly discussed that institution building needs to be driven by political actors in numerous cases and, hence, that is must be in the interest of these actors to craft those institutions.

China has embarked on a gradual and incremental transition path. It has developed important market-supporting institutions, but at times is still lacking the people to operate and enforce them. There are several general principles that can be derived from China's transition experience: (i) government reform is a key component of economic transition, because policy and institutional reform is effective only if authorities have strong market-enhancing incentives, face hard budget constraints and particular limits to their discretion; (ii) a reform program must be politically feasible, i.e. supported by the majority of people and in the interest of political elites: a reform that does not create many losers will be accepted *ex ante* and will also be sustainable *ex post*; (iii) sequencing: whenever it is politically feasible, "it is better to dismantle the existing institutions after the new ones are put in place, or allow the new ones emerge from the old, to avoid institutional vacuum"(Qian 1999: 47). Perhaps, China could have done even better by choosing even more appropriate reform measures, but what is crucial to recognize is that authorities managed to avoid fatal mistakes and to react pragmatically to changing challenges.

The Chinese transition experience also suggests that policymakers need to assume important, but in the course of time, changing roles in order to help overcome market and coordination failures and to foster economic growth and development. This, especially, holds in an underdeveloped transition economy in which particular markets do not exist or function (yet). This implies that the country's governance structure (as part of the overall institutional matrix) needs to be adaptively efficient as well. In this context, Chinese experiences indicate that governance quality is a relative as well as a dynamic factor: It is relative because the

[11] Note in this context, that policy advisors as well as the international donor community may be also adaptive to new experiences and insights. The World Bank (2000), e.g., explicitly concedes that so-called best-practice models regarding governance and institution building may not be feasible.

quality needs to be assessed with respect to the country's stage of development and regarding the governance quality of other economies which may compete for mobile factors of production. It is dynamic because different stages of economic development, varying international environments, and changing political side conditions may render hitherto effective governance structures obsolete and demand new institutional arrangements which are suitable to cope with these new challenges to policymaking.

In sum: China's institutional matrix has shown many adaptively efficient features allowing for numerous experiments and trial and error searches in a decentralized economy. Various transition institutions provided incentives for productivity-enhancing and risk-taking activities and ensured that potential future payoffs would be widely distributed across all strata of society. The Chinese governance system, in turn, also showed market-enhancing and adaptively efficient characteristics which fostered economic competion at home and on foreign markets, encouraged the development of transitional institutions, and facilitated the emergence of institutional complementarities. After all, it showed that gradual reforms or piecemeal social engineering, Chinese-style, help to minimize the differential between (unexpected or unintended) outcomes and intentions and, hence, can be more easily controlled in an adaptive way than big-bang or Washington Censensus-type of reforms.

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