

# Endogenous Institutional Change and Capitalism in China

Victor Nee  
Cornell University

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## 1 Introduction

The success of state-guided economic development in China underscores the need to explain the role of the state in giving rise to sustained economic growth. In 2008, despite the most serious global economic downturn since the Great Depression, China's economic growth was sustained at 8 percent per annum, the only major economy that avoided the severe economic downturn. Its economic growth continued to gather momentum amidst the global economic crisis. The central issue that needs to be address is why and how the very same state that presided from 1953 to 1978 over an all encompassing command economy, radical redistributive policies, and poor economic performance was then capable of guiding transformative capitalist economic development in another era? China's ambitious economic reform relied on a mix of top-down and bottom-up processes of institutional change while largely ignoring the advice of economists affiliated with the International Monetary Fund and World Bank. Some were economists who had drafted the blueprint for capitalist transition in Eastern Europe and the former Soviet Union. Frye and Shleifer (1997) attribute China's success in economic development as an example of the "helping-hand" of the state. This "helping-hand" explanation of the economic miracle has gained increased acceptance in development economics. With respect to the role of the state in China's economic miracle, two distinct approaches have emerged in the sociology of development,

reflecting contrasting views of the role of the state in market-oriented economic growth. On one hand, state-centered accounts attribute China's economic success to the organizational capacity of local government to monitor and intervene to promote the development of township and village enterprises (Oi 1992; Walder 1995; Whiting 2000; Huang 2008). The market transition approach takes issue with the top-down approach that focuses only on the "helping hands" of political actors. It instead emphasizes the causal effect of change in the relative power of political and economic actors, and a corresponding change in the role of the state through incremental shifts away from direct interventions in micro-managing the economy. By investing in the construction of an elite, rational-legal bureaucracy, the central government gradually has made the transition to a regulatory role through shaping macroeconomic policies and enacting new formal rules governing markets (Nee and Oppen 2007). I contend that the limitation of the state-centered perspective is that it is unable to explain the bottom-up dynamics of emergent capitalist economic development in China.

A focus on China as a study of robust entrepreneurial action and capitalist economic development was not predicted. The consensus view of Western economists was that Eastern Europe and the former Soviet Union would be most likely to make an early and successful transition to market capitalism. After all, these were industrial economies with highly developed human capital and large urban populations. In 1978, China was an impoverished agrarian economy with 80 percent of its population in subsistence agriculture, with a per capita investment in education at the same level as that of Bangladesh. Not only were the new political elites of Eastern Europe and the former Soviet Union supportive of the "big bang" approach designed by economists, but they

also adopted the entire tool kit that combined economic and political reforms into the same institutional design of top-down rapid transition to capitalism. Not expected was the opposite outcome, as Stiglitz's (2002: 6) underscores: "While in 1990 China's gross domestic product (GDP) was 60 percent that of Russia, by the end of the decade the numbers had been reversed. While Russia saw an unprecedented increase in poverty, China saw an unprecedented decrease." According to the United Nation's assessment, from 1978 to 2005, China experienced an unprecedented decline in absolute poverty, the largest and most rapid in human history, with more than 340 million people shifting out of subsistence agriculture into market-oriented productive activity. Concomitantly, a newly affluent parvenu stratum of entrepreneurs and professionals has arisen to form a new class whose wealth is rooted not in the political order—as with the old state socialist redistributive era elite—but in the rise of a market capitalist economy.

Several observations are in order. First, China's explosive economic growth has the self-reinforcing endogenous dynamics of sustained economic growth. Within a year, China's GDP is expected to exceed that of Japan's to become the second largest economy in the world. With the huge economic stimulus channeling \$685 billion to fund ambitious infrastructure projects and state-owned enterprises, economic recovery and growth in China has become an indispensable economic engine of global economic recovery. Not surprisingly therefore, international economic institutions now view China as the latest entry in the pantheon of successful developmental states, along with South Korea, Taiwan, Singapore and Japan (Stiglitz 2002).

Second, China's policy model clearly resembles core features of the developmental state in East Asia (White and Wade 1988), building on a strong

authoritarian national leadership and an elite state bureaucracy pursuing developmental goals and industrial policy (Wade 1990). It is not however, well understood which type of state action has actually given rise to transformative economic development. In this sense, as Wade (1990: 26) rightly criticizes, developmental state theory has little to say “about the nature of policies and their impact on industrial performance.”

Lastly, the mechanisms giving rise to transformative economic development are not yet well understood. Is China’s economic success due to the government’s organizational capacity to monitor and intervene in the firm’s decision? According to Walder (1995), when government has clear incentives and the ability to monitor firms and enforce their interests as owners, government officials can replace the entrepreneur as the mechanism driving gains in productivity and sustained market-oriented economic growth. Or is China’s success, quite to the contrary, built on bottom-up innovations giving rise to the construction of informal economic institutions and the government’s liberalization of product and labor markets; ambitious investments in infrastructure (i.e. transportation, education, regulatory apparatus) and institutional change, leading to more secure private property rights and incentives for economic actors?

## **2 Limits of top-down approaches to economic development**

Building on the view that the polity, as the enforcer of the rules of the game, is “the primary source of economic performance” (North 2005: 57), state-centered theory underscores the role of political actors. The idea that politicians play a key role is substantively undeniable and intuitively appealing. With its comparative advantage in violence, the state operates as a monopolist that enjoys substantial cost advantages in

institutional change. By contrast, a free-rider dilemma constrains the ability of economic actors to assume the cost of collective action to establish and enforce the rules of the game. Thus it follows that “institutional innovation will come from rulers rather than constituents since the latter would always face the free-rider problem. The ruler will, on his side, continue to innovate institutional change to adjust to changing relative prices since he has no free-rider problem” (North 1981: 32).

The problem with the top-down approach is that it cannot explain the self-reinforcing, endogenous rise of China’s private enterprise economy, which is the very foundation of capitalist economic development driving private wealth accumulation. During the first decade of reform, the central government explicitly outlawed private enterprise as an ownership form in the transition economy. Reform leaders not only enforced rules against private enterprises, but predatory taxes and expropriation by local government of assets and wealth of peasant entrepreneurs highlighted the problem of insecure property rights for privately owned assets and wealth. It was not until a decade after the start of economic reform, when the private enterprise was already growing rapidly, that the first constitutional amendment in 1988 eventually conferred legal status to private firms. The corresponding law—“The Temporary Regulations of Private Enterprise” (July 1988)—governing private firms with more than seven wage laborers (*siying qiye*), however, still reflected the government’s intent to limit the private sector to a subordinate, if not inferior, role.

Private firms make up the largest and most dynamic sector; yet the formal rules crafted by the political elite continue to favor state-owned enterprises and state controlled corporations. This is seen clearly in the lending policy and practices of China’s state-

owned financial institutions, which were a key feature of an institutional design to deter, if not entirely block, the rise of the private enterprise economy. In 2008, the central government announced a massive economic stimulus program of USD 585 billion. A rapid decline in global consumer demand affected all sectors of the industrial economy. Relative to China's gross national product, the stimulus program was the largest of the major economies. The government channeled the stimulus money to state-owned banks, which in turn extended a torrent of low-interest credit to local governments to support mega-infrastructure projects and to state-owned enterprise. Despite official figures showing that small and medium sized firms employed 75 percent of China's workers and produced 68 percent of the gross industrial product in 2008, private firms have been virtually excluded from direct support in the form of preferential access to low interest loans. Though private firms sought economic stimulus money, state-owned banks routinely rejected loan applications submitted by private firms. Instead the massive economic stimulus has provided a huge subsidy to local governments and large state-owned enterprises and public corporations.

Consider this counter-factual: If political actors had had their way, the seeds of capitalism, sowed as an unintended consequence of reform policies, would have been contained by state-mandated rules restricting the size of private firms to individual household production. Insofar as the political logic of reform in China was aimed at safeguarding and promoting the public ownership economy, top-down analysis has little applicability in explaining the construction of economic institutions enabling, motivating and guiding the self-reinforcing dynamic rise of the private enterprise economy. State-mandated rules are imposed on economic actors by political actors. As Greif (2006: 40)

notes, “identifying institutions with politically devised rules....restricts them to outcomes of the political process.”

### **3 Social mechanism in bottom-up economic development**

I assert that the defining feature of transformative economic development in China is the “bottom-up” construction of informal economic institutions. My argument is that informal economic institution enabled entrepreneurs to surmount formidable barriers to market entry and discriminatory policies of the state. From outside the established economic order dominated by state-owned enterprises, entrepreneurs developed economic institutions that enabled them to compete and cooperate in spite of disadvantageous or simply absent formal rules.

Where do institutional innovations come from? In addressing this question, I extend the sociological approach to examine the bottom-up sources of economic institutions. As Stark (1992: 300) observed in post-communist Hungary, “the introduction of new elements most typically combines adaptations, rearrangements, permutations, and reconfigurations of existing organizational forms.” Although North also underscores the importance of informal constraints, in his framework, informal constraints play a role as the “cultural filter” providing “continuity so that the informal solution to exchange problems in the past carries over into the present and makes those informal constraints important sources of continuity in long-run societal change” (North 1990: 37). Greif (2006: 9) notes that in North’s framework the stability of institutions is “attributed mainly to frictions in the process of institutional adjustments (e.g., the costs of changing rules) or to the impact of exogenous informal institutions, such as customs and traditions.” In other



words, North's explanation of institutions turns on exogenous factors wherein stability stems from informal constraints—custom and tradition—and institutional change emanates from purposive action of politicians, but not from shifts in social norms.

Two mutually related mechanisms combine to generate endogenous institutional change: First of all, the replacement of state bureaucratic allocation by market coordination involves a shift of power favoring direct producers relative to redistributors (Nee and Oppenheimer 2009). Almost imperceptibly, but accelerating following tipping points, self-reinforcing shifts in the institutional environment cause traditional state-owned enterprises of the old redistributive economy to lose market share to hybrid and private ownership forms. Further, the greater autonomy afforded by decentralized markets enables entrepreneurs to construct informal arrangements that build from ground-up the economic institutions of a private enterprise economy. Second, with marketization, rewards are increasingly based on performance rather than the strength of political connections. Lastly, the most effective way to stimulate productive entrepreneurial activity is to diminish relative rewards to unproductive or destructive rent-seeking and increase payoffs to productive entrepreneurial activity (Baumol 1990).

The bottom-up construction of informal economic institutions has enabled private firms to compete and cooperate in China's market economy. In the Yangzi delta region, the epicenter of market capitalism, a self-reinforcing dynamics of industrial cluster formation is at the root of a cumulative growth process. In the three provinces of the Yangzi delta region—Zhejiang, Jiangsu and Shanghai—extensive multilateral clusters of private firms self-organized in industrial niches provide the institutional matrix of competitive advantage. The simple definition of industrial cluster used widely in

economics, geography and organizations is a sectoral and spatial concentration of firms connected through vertical or horizontal relations (Porter 1990; Krugman 1991). Marshall (1920) pioneered the idea that spatial concentration of specialized producers gives rise to endogenous economic growth. First, it ensures a constant market for skilled workers, drawing in and training continuously specialized human capital. Second, agglomeration of productive assets enables individual manufacturers to economize on investments through subcontracting arrangements with specialized subsidiary firms. Third, spatial concentration fosters network effects that facilitate innovative activity such that, “if one man starts a new idea, it is taken up by others and combined with suggestions of their own; and thus it becomes the source of further new ideas.”

The defining feature of industrial clusters is that firms in a niche are interconnected entities that compete and cooperate in spatially proximate locations. Industrial clusters not only improve information flows, but social processes embedded in networks lock in business norms sustaining trust and cooperation within close-knit communities of manufacturers. In his ethnography of an industrial cluster of high-end garment manufacturers in New York City, Uzzi (1996: 176) details how on-going workaday connections between Italian, Jewish and Chinese firms give rise to trust and fine-grained information. “I found that embedded ties entail joint problem-solving arrangements that enable actors to coordinate functions and work out problems ‘on the fly.’ These arrangements provide more rapid and explicit feedback than do market-based mechanisms such as ‘exit’ (Hirschman 1970); they enable firms to work through problems and to accelerate learning and problem correction.” In the Yangzi delta region, early founders of private firms had no alternative but to rely on government sources for

their supplies. As marginalized, semi-legal entities located at the low end of the pecking order in the manufacturing sector, private firms often experienced long delays and poor quality from government suppliers (*Jingji Yanjiu Cankao* 28/09/1994). It was the rapid entry of new private start-up firms and bottom-up formation of integrated “industrial clusters” (*chanye jiqun*) and “production chains” (*chanyelian*) of specialty suppliers, which allowed private producers to decouple from government-owned suppliers and firms. Through mutual cooperation and joint problem solving, private producers reduced environmental uncertainties and enhanced strategic capability development. Through these bottom-up processes from within discrete industrial clusters, entrepreneurs in the Yangzi delta region constructed autonomous networks of suppliers and distributors decoupled from the state-controlled industrial and commercial sectors of the transition economy.

Once an integrated industrial cluster and production chain is established, expected operational costs decline. More and more entrepreneurs and vendors in accessory industries are drawn in by the critical mass of specialized human capital and organizational resources. A great majority of the firms in an industrial cluster and production chain are private enterprise ranging in size from household firms to very sizeable private enterprises in the same niche that compete in the global economy. In the mountainous southwestern region of Zhejiang province, for example, when an entrepreneur starts up a new business in the city of Yong Kang, they are able to draw on an industrial infrastructure of specialized human capital resources, subcontractors, raw material suppliers and a distribution network of their industrial cluster. Manufacturers in industrial clusters strongly believe that they cannot find a better location for producing

kitchenware and stainless steel products. Ying Weizhong, the manufacturer of professional knives said, “It is better to be here than in Shanghai. There’s more information, you can find parts, people, and supplies close at hand and at the best price and quality.” Yong Kang is a city of about 340,000 people with over 15,000 registered private firms, about 3,000 of which market their products overseas with the remaining 12,000 serving as subcontractors, suppliers and distributors of the export-oriented firms. The scale of the manufacturing economy is such that nearly every household has someone involved manufacturing.

The competitive advantage of the manufacturing economy in the Yangzi delta region is rooted in multiple overlapping industrial clusters. No other region in China has a comparable density of multiple cluster productions. Most municipalities in the region are home to several discrete industrial clusters, which evolved from mimicking the successful early start-up firms in the industrial niche. As new players entered into the market, a self-reinforcing, bottom-up process of specialization and differentiation gives rise to the formation of industrial clusters. This spatial proximity of hundreds, and often thousands, of producers operating in the same industrial niche allows for rapid pace in the production cycle from purchase order to manufactured product. Producers can count on all the needed component parts supplied rapidly by subcontractors ready to produce. Access to a multitude of small satellite firms allied to the mother firm as spin-offs of start-up firms—employees and friends—provides for a ready ensemble of subcontractors who are connected through long-standing personal ties and that have the necessary human capital. As small firms, they are adaptive, flexible and capable of specialized production on a short time schedule.

Clearly, there is a close parallel in the bottom-up institutional innovations that gave rise to industrial clusters and production chains in the Yangzi delta regional economy with the Emilia-Romagna region of Italy (Brusco 1982). The basis of regional competitive advantage is linked to the social structure of close-knit communities of manufacturers, suppliers and artisans and to the effectiveness of social norms in enabling, motivating and guiding cooperation. There is the additional parallel that both regional governments—Emilia-Romagna and the Yangzi delta region—are controlled politically by communist parties. In both regions, however, sustained, high levels of economic performance do not rest on top-down central government measures, but on bottom-up dynamics of entrepreneurship rooted in local networks and norms.

#### **4 Conclusion**

The central thesis of North's state-centered theory is the proposition that successful evolution of political institutions and credible commitment by political elite to formal rules securing property rights provides the necessary and sufficient conditions for economic growth to take place. As North (1981: 32) asserts, "institutional innovations will come from rulers rather than constituents since the latter would always face the free rider problem." In this "institutions-as-rules" account, the evolution of institutions favorable to economic performance is a top-down process led by politicians who control the state. Hence, in Third World economies, the counterfactual is that if formal institutions secure property rights and check predatory action by the political elite, then sustained economic growth would follow. Greif (2006: 7) observes that this framework "is very useful in examining various issues, such as the rules that politicians prefer and

the contractual forms that minimize transaction costs.” But, he argues that its limitation stems from the problem that behavioral prescriptions—formal rules and regulations—that reflect what politicians prefer are “instructions that can be ignored.”

The study of founding processes of private firms in the Yangzi Delta region provides first insights into central micro-mechanisms enabling the rise of capitalism. A duality of agency and social structure organizes the analytic narrative in which the entrepreneur is the central agent who drives the institutional innovations that give rise to the private enterprise economy; once established, informal economic institutions structures the framework of entrepreneurial action. Entrepreneurship in the Yangzi delta region was not fueled by exogenous institutional changes. When the first entrepreneurs decided to decouple from the traditional socialist production system, the government had neither initiated financial reforms inviting a broader societal participation, nor had it provided property rights protection or transparent rules specifying company registration and liabilities. Instead, it was the development and use of innovative informal arrangements within close-knit groups of like-minded actors, which provided the necessary funding and reliable business norms. This allowed the first wave of entrepreneurs to survive outside of the state-owned manufacturing system.

This bottom-up process resembles earlier accounts of the rise of capitalism in the West. Similar to Weber’s narrative of economic development in Manchester and Northrhine-Westfalia, the drivers of institutional change in the Yangzi delta came from outside of the established economic order. As in 19<sup>th</sup> England and Germany, the first entrepreneurs were not part of the political or economic elite, but came from modest social background. As Li Shufu, the founder and CEO of Geely Automobile notes, his

generation of capitalists were “just a bunch of simple farm boys,” many coming from impoverished farming households. In reporting on Geely’s bid to buy Volvo from Ford, the *Wall Street Journal’s* description of Li’s socioeconomic origin recapitulates the bottom-up account we present (Leow 2009):

“Behind Geely’s transformation is the chairman, Mr. Li, a self-described workaholic who most nights sleeps inside the company’s headquarters building in Hangzhou. Born in 1963 to poor farmers in Taizhou, about 250 miles southeast of Shanghai, he came of age during the era of economic reform that began in the late 1970s.

When he finished high school he used his graduation gift of 100 yuan, about \$14 today, to buy a used camera. He then opened a photo studio for villagers. With the money he earned, he launched a business stripping gold and other rare metals from discarded appliances and machinery. Later, he opened factories to produce refrigerators and freezers, and then construction materials.

By the early 1990s Mr. Li was thinking about building cars. But at the time, China’s central government barred private companies from the auto industry. So Mr. Li began making motorcycles, while still buying cars and stripping them down to learn how they were made. In the late 1990s, as official restrictions began to ease, Mr. Li founded Geely. He came up with the company’s first auto prototypes based loosely on competitors’ models and began selling cars in 2001.

These were the types of first deviators, who simply did not mind the low social status, or the stigma of extra-legal activities. Mimicking of like-minded people, then gradually led to the development of norms of mutual help and organization in cluster-like local business networks. It was through this process of imitation that the once stigmatized deviators turned into capitalist role models spearheading a broad based social movement dynamic of firm founding, which could no longer be dismissed as a negligible extra-legal

sector of the economy. The success of China's developmental state was to recognize the importance of bottom-up economic development. Although the state continues to favor state-owned and controlled firms, it has cumulatively accommodated robust bottom-up entrepreneurial action through macroeconomic policies and legal reform to legitimize the private enterprise economy and secure property rights. Revenue maximization motivates the government's accommodation with entrepreneurs and capitalist economic development. The state would not have been accommodative, however, if the private enterprise economy was not already established as the most rapidly growing source of private wealth creation, employment, tax revenue, technological innovation and sustained economic growth. The rise of private enterprise-led capitalist economic development was not *because* of the state, but *despite* the state's earlier effort to block its development.



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