

**THE INTERDEPENDENCE BETWEEN POLITICAL AND ECONOMIC
ENTREPRENEURSHIP**

BARBARA KRUG

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Email address author	Bkrug@fbk.eur.nl
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The Interdependence between Political and Economic Entrepreneurship.

Barbara Krug

Rotterdam School of Management, F 3.76

Erasmus University Rotterdam

Abstract: The Chinese economy has developed rapidly despite two major constraints: ill-functioning markets and a socialist past, both of which caused an environment of unenforceable contracts. In this situation the need to pool resources and to govern relational risk was paramount to the development of a private sector. While modern organisation (transaction cost-) theory can explain why and to which extent entrepreneurship in China is based on collective agents, an analysis of the (local) political market is needed to explain why China's villages provide the much needed (and valuable) public goods in form of property rights protection and contractual security. Decentralisation and jurisdictional competition facilitate the writing of a new "common law" as well as the "discovery" of new forms of collective action.

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I. Economic growth and local industry.*

Compared to January 1979 when the reform era began, the Chinese economy today certainly looks different. There have been unprecedented growth rates in both national aggregates and personal household income. Productivity increased thanks to the more widespread use of modern technology, capital imports and liberalisation in the market for information. However, to conclude from this that China is well on its way toward a market economy may be immature, not to say misleading. The private sector still only contributes less than 14% (1997) of overall production, while China's state sector is inefficient, non-competitive and a major burden for the national budget and the taxpayer (Oi 1995; Lardy 1995). Statistics reveal that the engine of growth and the major source of revenue from which the state sector are alimented are a specific kind of firm – known as Township and Village Enterprises (TVEs). Since the middle of the Eighties these firms, year by year, have generated one third of state revenue and between thirty and forty per cent of foreign exchange, both figures indicating the TVEs' domestic and international competitiveness.

Other characteristics of the TVEs highlight the differences in China's economic construction when compared to the recent development of Central Europe, let alone the countries of the former Soviet Union. First, these firms were established in the countryside and compared to the European examples this led to a much more decentralised structure within the industrial sector. Second, the TVEs created a new middle-class of entrepreneurs and professionals (*Mittelstand*) who form a considerable constituency in the political market (Goodman 1994). Third, TVEs are a puzzle for economic analysis, as they do not fit neatly into conventional models of firms. They are neither socialist (state) firms (Furubotn and Pejovich

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1974) nor are they firms based on private property rights and contracting (Walder 1994; Furubotn and Richter 1997, 321-409). Attempts to force them into one of these two accepted categories with the help of ad hoc assumptions, misses the point as will be shown presently (Nee and Matthews 1996; Putterman 1995; Oi 1995; Krug 1996).

A more promising way to explain the emergence and behaviour of TVEs is to abandon preconceptions and undertake empirical research. This research needs not only to be countryside-based but also to consider both the inner workings and environments of the TVEs, particularly focussing on the *entrepreneurship* centred within this form of a firm. The following article is based on such research undertaken during 1996-8. 293 political cadres, managers, professionals and owner-operators were interviewed, and of these, 133 real entrepreneurs, i.e. those who take a market risk in return for entitlements to residual profit (or loss), could be isolated².

Research suggests that the best way to sum up the Chinese economic transformation is to claim that *China's villages experienced political as much as economic entrepreneurship*. Such a summary demands an analysis of entrepreneurship and the workings of the political-economic market at the local level (see Nee 1989, Oi 1995, Krug 1997b). The analysis offered here claims first, that entrepreneurship in China entails finding solutions to the specific economic problems posed by an economy best characterised as an *emerging market with a socialist heritage* (Section II). Second, it also claims that in order to unleash entrepreneurship the political and social environment needs to offer a premium high enough to make such an effort worthwhile. However, what is specific to the

² The following is based on research organised and financed by the Institute for International Studies at the University of Technology, Sydney and funded by the Australian Research Council. With the help of local staff from the University of Finance and Economics in Taiyuan, Shanxi Province, about a two hundred interviews of entrepreneurs, managers and cadres are being conducted every year since 1993. The danweis were chosen from the counties and villages. The interviews were open in the sense that no standardised questionnaires were used. The reason for this is that the introduction of private forms of ownership, the commercialisation in economic exchange, and the introduction of markets and market related taxation leads to new "words" and concepts which are not easily understood. In order to avoid "wrong" answers, the interviews must allow for discussion and explanations. One striking example is the word profit. In most cases, profit is - at best - related to "profit before tax". What is meant however is that in the Chinese way of thinking overall profit ought to be shared between the company, its owners, its workforce and the state, mostly the village that gives settlement rights. Such a view has consequences for the *behaviour of the firm*, as will become clear in what follows.

Chinese economy - or any other emerging market with a socialist past – appears to be that entrepreneurship depends on collective action embedded in a supportive organisational structure. This need for organisation adds a *relational risk* to the more conventional market risks or moral hazard (Section III).³

The empirical research shows that the Chinese found ways and institutions by which these relational risks could be mitigated and diversified. Essential to these processes was that in establishing private exchange they could rely on *identifiable agents* or *Trusted Third Parties* which create a network (and collective governance) around economic enterprises⁵. These networks ensure manoeuvrability outside state regulation as a major component in the individual firm's behaviour, while the establishment of *mutual dependence* between different members helps to govern the overall network. Mutual dependence between the village leadership and village entrepreneurship prompted further institutional change: the creation of a political market with decidedly more "democratic" elements and local self-governance than in the socialist past (Section IV).

As will be seen in what follows, it is the local political market where the demand for collective action and those institutions which are necessary to sustain private exchange and production meet with the corresponding supply. At the local level state agencies can optionally play the role of a Trusted Third Party, individual cadres have an incentive to remain as a valuable "asset" within the network of firms, and village governments have positive incentives to provide legal protection, infrastructure and (favourable) tax legislation (Section V)⁶. Rent-seeking does not completely strangle the economy because of changes in

³ This argument reverses the argument that the establishment of jurisdictional systems as a public good considerably lower transaction costs. For the transaction costs in contracting, see Cooper and Ulen 1997; for the functioning of economies that do not know legal systems, see Posner 1988.

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⁵ At first sight, this seems to contradict the conventional claim that the transition will be the quicker the sooner unanimous markets are introduced. Lipton and Sachs 1990.

⁶ See also Qian and Weingast 1997; Qian and Roland 1998.

the national political market. Local governments have never been part of the Party-State machinery in the sense that they needed to compete for shares of the Party-State budget. However, increasingly with reform local governments have needed to create and cultivate their own tax base (Section V). While jurisdictional competition with other local governments and with privately organised networks keeps overall taxation low, increasing positive demand for locally established public goods (legislation, law enforcement, and infrastructure) does not allow a "race to the bottom" to take place (Mueller1998a).

II. The situational constraints of the Chinese economy

As shown elsewhere (Krug 1997b) the Chinese economy remains characterised by "emerging" (or perhaps better "nascent") markets which coexist with socialist firms and distribution channels still protected by the central political leadership. Both factors limit the courses of action private economic agents can take regardless of whether private exchange in certain sectors is "legally" permitted or not.

In general, emerging markets can be characterised by ill-functioning capital markets (markets for risk), ill-functioning markets for information, and highly fragmented markets for goods and services (Krug 1997b). Thus, the information value of the price mechanism is rather limited. High prices can reflect scarcity, but might also for example indicate the existence of local monopolies. To follow the direction of price changes under such conditions without searching for additional information would be foolish. Information costs in emerging markets are high since most information relies on gossip, which makes it both crucial yet costly to double-check the source of information.

The difference between emerging markets with a socialist past and others, as for example in Latin-America, is that the socialist past adds to the transaction costs. First of all, economic construction and entrepreneurship cannot rely on privately accumulated capital. Instead investment needs to be financed from current savings. For this reason, the ability to pool savings, as well as ideas, manpower, and land for industrial sites defines a major threshold for private entrepreneurship. Second, in the Chinese case, where the Chinese Communist

Party still has a major role to play in the economy and where doing business therefore depends on permission granted by the State, accumulating licenses which in most cases are linked to individual economic agents (Krug 1997a) is decisive for any private economic activity. In other words entrepreneurship depends on collective action and not just on individual endeavour. Last, but not the least, there is (still) a confiscation risk due to unenforceable private property rights. Confiscation here must not be seen as limited to the confiscation of assets, but includes the hold-up of residual income when, for example, village cadres extort "voluntary" contributions for road-building or health care after net profit is known.

The non-operationalisation of a commercial law, in particular a liability law, places a further burden on private exchange. In other words, economic activities need to be co-ordinated in an *environment of unenforceable contracts* with accompanying high transaction costs. To claim that the creation of an environment of enforceable contracts is crucial for both transaction cost reduction and the better functioning of markets is an easy exercise for economists. However, there is little literature on how this transformation can be achieved. In the case of China there is an additional need to explain how under such circumstances economic actors find ways to establish and effectively manage companies which quickly enough become strong competitors to the larger, better equipped State-owned firms and subsequently to firms from neighbouring countries within the Pacific market.

III. Entrepreneurship "Chinese-style"

When entrepreneurship cannot rely on private capital and functioning capital markets, mobilisation is decisive when it comes to establishing a private sector. Pooling of capital and other valuable assets translates into the pooling of individuals who possess such assets. This being the case, entrepreneurship becomes a specific kind of collective action. An entrepreneur would, then, be someone (an individual or collective actor), who can get this collective action organised, whereby organisation refers to the design of any incentive structure which guarantees an effective use of, and appropriate remuneration for, all resources supplied by the individual member or members.

A great part of the literature assumes that some aspect of Chinese culture, such as Confucianist values, or *trust* can explain why the Chinese find it easy to turn entrepreneurial (Fukuyama 1995; Huntington 1993; Redding 1990, 1996). It is argued either that there is no relational risk since honesty and trust are an individual predisposition which determines behaviour, or that the tradition of personal connections (*guanxi*) ensures transaction costs are close to nil. These claims do not survive empirical scrutiny (Rozman 1993, Krug 1997c, Bond 1991). As was shown elsewhere, not only the Chinese economy, but any economy where the co-ordination of economic activities depends on personal networks and *patronage*, is burdened with high transaction costs and runs the risk that the entrenched interests will make sure that any expansion of markets (leading to transaction cost reduction) will be difficult to attain (Gambetta 1993; de Soto 1990).

A more promising interpretation of the Chinese propensity towards entrepreneurship comes from linking modern Organisation Theory with Public Choice theory in order to develop insights into the process by which economic interests translate into institution-building (Mueller 1998a). If entrepreneurship is not to become stuck in the quagmire of "quick-money" deals, then long-term business and "share-holder" relations need to be secured with the help of binding agreements which can be enforced by other than (Western) conventional means, such as contracts and court orders. Entrepreneurship is then a formidable task in the form of a *procedural ability* to deal with the relational risk (Macaulay 1963). The notion that entrepreneurship deals with relational risk is found in modern organisation literature (Powell 1990; Nooteboom et.al. 1997; see also Furubotn and Richter 1997, 404-412) and is clearly not China-specific. However, the Chinese case is special in that procedures need to be established and public goods which allow agreements to be enforced need to be provided in a political environment that does not acknowledge the *rule of law*.

1. *Organising production*

The need to pool resources or ideas points towards entrepreneurship in the form of collective action rather than towards waiting for a Schumpeterian (single) entrepreneur.

Subsequently, the establishment of new (or "restructured") firms depends on an agreement with those who possess economically valuable resources. In the context of the Chinese inherited socialist administrative structure, the village is such a group of those who possess economically valuable resources⁷. Leaving aside for a moment the impact of Party-State control in the villages, the village as a "community" was the only economic agent which possessed or controlled resources such as land and manpower outside of central planning when the reforms started. Certainly in China, in comparison with Europe, there are no objections to the notion of villages as the "natural" owner of resources. In the language of Posner (Posner 1988; Krug 1997a), the villages possessed the *initial property right*. It was left to them to look for ways to further allocate these resources.

As was shown elsewhere (Krug 1997b), the best way to model the newly established TVEs based on inherited local industry is to describe them as *commons*, or jointly-owned resources (JOR) in the sense developed by Ostrom. (Ostrom 1990) However, a difference to Ostrom's conceptualisation is that TVEs do not centre around a (exogenously) given resource whose potential economic value is apparent to everybody, as for example the "commons", or fishing ponds, but rather that the value of the (common) resource needs to be established first. It is here that entrepreneurship plays a role. Entrepreneurship still starts with a good idea, but one which can put the given resources within the village (capital goods from the old village firms, personal savings, manpower etc.) to good use. On the one hand, the village must offer high rewards for any kind of entrepreneurship. On the other hand, somebody must have the idea and must convince the village community that it is worthwhile to give them control over resources in return for future income (or safe workplaces). As theory on JOR has shown, three problems need to be solved: asymmetric information, credible commitments, and (long-term) binding agreements.

2. *Asymmetric information*

⁷Unlike Stalin, Mao Zedong did not destroy the villages. On the contrary, after the failure of the Great Leap Forward (1958-60) and again during the seventies, the village became the "owner" of local industry, a sector that was expected to complement workplaces in agriculture.

To agree that something ought to be done with the locally available resources is only a necessary condition for change. More decisive is the ability to "pick a winner", in the form of either a good idea or a dynamic entrepreneurial spirit, so that something is done with the local resources which delivers workplaces and income to the village. A good idea can refer to both new ways of co-ordinating resources (i.e. changes in production techniques and shop floor innovations) and to new products, which are assumed to be in short supply in the larger market. Regardless of the plan brought forward, there is, first of all, the problem of asymmetric information. The advantage of TVEs which often resemble an *employee buy-out with Chinese characteristics* is that they can rely on insider knowledge, since the inherited workforce frequently knows by which means overall productivity can be increased.⁹ Villages which need to start a new firm or a new production line face another problem. In these cases, the village community needs to "trust" the sincerity of the person who proposes an initiative while in turn the innovator must trust that the idea is treated in confidence. As is known, there are two conditions which help to mitigate the inherent moral hazard problem: *information impactedness* (Williamson 1985) and *open bidding processes*. Both can be found in Chinese villages. Virtually all villages relied on the pool of village members (i.e. people known intimately for many years) to pick the best entrepreneurial idea at the beginning of reform, regardless of whether 'auctions' (of any kind) were used for re-allocating resources or whether the village community voted for a specific idea. Either method can help select the best way to make use of village resources, but neither ensures that the entrepreneur or manager, once chosen, will remain honest. This points to the problem of credible commitments.

3. *Credible commitment*

⁸The most striking example of the value of *tacit knowledge* is provided by the agricultural sector, where a change in ownership rights unleashed an unprecedented increase in productivity and output. The interviews showed the same effect. The village as a whole, or at least some members who subsequently had a good chance to be appointed manager, knew exactly which change was necessary to make production more efficient, or else the goods produced more attractive.

⁹The most striking example of the value of *tacit knowledge* is found in the agricultural sector where a change in ownership rights unleashed an unprecedented increase in productivity and output. The interviews reflected this effect. The village as a whole or at least some of its members - who subsequently had a good chance to be appointed manager - just knew which changes were necessary to make production more efficient, or the goods produced more attractive.

In fully-fledged market economies, the problem of credible commitment is mitigated by functioning capital markets: risk is spread over a large number of potential investors, each of whom *bets* on success and each of whom will lose only a tiny share of personal savings. As a result the capital necessary for transforming a new idea into a new product or production technique can be acquired at low cost. In addition, the legal system ensures ways to recover (at least partly) the initial investment in case of default.

In any emerging market the situation is different. If an entrepreneur wants to mobilise, for example, capital, then he has to make sure that potential investors – even if these are friends, neighbours or members of the family - believe in the sincerity of the project. One way to signal sincerity is to offer a collateral, for example private assets. A common feature of TVEs is that the person whose idea was chosen and who in most cases is then appointed manager has to put all his private savings into the new company. The risk-averse behaviour, which looks to the provision of collateral, is balanced by the kind of contract most managers work with: they enjoy a low, fixed salary and a profit-linked bonus. As the literature on crop-sharing shows, such a contract allows risk to be shared while also sharing the innovation rent (Cheung 1969) and by doing so it provides an incentive for risk-taking.¹²

However, not every promise can be backed with a credible commitment in the form of collateral. In day-to-day business other ways need to be found to turn promises into binding agreements.

¹⁰How it came to be that Chinese villages revived the institution of crop-sharing contract will be explained later.

¹¹The fact that most of these contracts are unwritten should not delude us: their obligations are acknowledged as binding.

12. Chinese villages' revival of the institution of crop-sharing contracts is explained later.

4. *Binding agreements*

As the literature on joint-owned resources (Ostrom 1990, see also Greif 1993) suggests, entrepreneurship in China must tackle the problem of binding agreements in a number of areas:

1. The firm most importantly needs to stay in business. For this reason, long-term business relations need to be established. In order to take the firm's economic nexus beyond the boundaries of the local community, business relations need to be established beyond the pool of exchange partners with whom one stays in frequent contact (and with whom one could make use of information impactedness).
2. Since the TVE is a joint-owned resource, sharing rules need to be agreed upon so that each individual member (share-holder) sees his expectations met. The individual share of overall return needs not be restricted to monetary income, or dividends, but can also take the form of a guaranteed workplace, health care, or other benefits.
3. A statute, or "constitution" is therefore necessary which allows participation of all owners, which makes the management accountable to the village community, and which promulgates collective decision-making for further changes in the firm's policy.

In other words, in an environment of unenforceable contracts and insecure private property rights, the increasing economic value of assets will lead to a positive and increasing demand for a specific public good, namely *legislation* which facilitates the operation of binding agreements, commercial exchange contracts, and *constitutions* for each joint-owned resource and appropriate enforcement agencies (North and Weingast 1989, Ostrom 1990). Constitutional economics expects such legislation to somehow emerge through collective action and to be co-ordinated in the political market. However, little attention is usually devoted to the manner of the legislation's emergence in authoritarian regimes. On the contrary, it is usually argued that without party competition (if not Western-style democracy) there will be an underprovision of this kind of legislation with the result that the private sector shies away from long-term investment and long-term contracts.

China, on the other hand, does not provide evidence of an aversion to private sector long-term investment. Regardless of whether attention focuses on the "real" private sector or on the several mixed forms of private-collective ownership, both are equally unprotected by "socialist law" and are heavily engaged in long-term investment. Indeed, the development of TVEs as joint-owned resources goes together with institution building around the TVEs. First, Chinese villages established networks as a means for governing the relational risk. Second, they formed a *mutual dependence* between the political leadership of the village and the villagers in order to ensure compatibility of (self-)interest. Third, they designed *statutes* around the TVE, in particular reviving the notion of contracts as the basis for business dealings with both suppliers and customers, and for formulating agreements between the owners of the TVE and the managers.¹³ An unintended outcome of these three factors was that the local political market became a platform for the complementary provision of public goods, as well as control of local government.

IV. Managing the Relational Risk

1. Privately-organised collective action: Networks

One way to keep relational risk low is to rely on networks where norms of reciprocity and reputation enforce agreements. Such networks are *Trusted Third Parties* (Nooteboom 1999) in the sense that each individual agent expects this institution to effectively screen individual behaviour. This screening effect will limit moral hazard to the effect that transaction costs within the networks are lower than in any other alternative, regardless of whether these are part of the market or the state-controlled planning system. The literature recognises two

13. The fact that most of these contracts are unwritten should not delude us: their obligations are acknowledged as binding.

competing interpretations of why networks are transaction cost saving devices. One is that networks constitute part of the individual's social identity with the consequence that individual members will voluntarily forego opportunistic behaviour (see for example Etzioni 1988). The other assumption refers to the enforcement mechanism inherent in networks: while the relatively small number of members creates a kind of "associational proximity" and (subsequently information impactedness) social sanctions can easily be employed in case someone defaults (Coleman 1990).

Both interpretations are supported by the empirical research. Chinese economic agents start with the assumption that they are part of one or more networks (communities), and that these allow them to acquire and co-ordinate resources at lower costs than the nascent markets (see also Granovetter 1985). However, Chinese economic agents know better than to rely solely on the goodwill of network members. Instead, social sanctions - such as the investigation of records to see how far the One-Child-Policy was implemented in the family of the entrepreneur, ¹⁶ denying Party membership, or turning the violator's family into outcasts within the village community - are used to enforce norms of reciprocity. Chinese economic agents would not object to those studies that claim that it is the sanctions, rather than participation in a social identity, which keeps the networks effective (Yamagishi 1986; Yamagishi and Takahishi 1994).

It is crucial to acknowledge that firstly, it is not the extended family which generally stands at the core of a network, ¹⁷ and secondly, that each firm is part of several competing networks.

¹⁴In the province where the empirical research was done, neither the managers (or commercial) entrepreneurs nor the local cadres had followed the One-Child-Policy, thus leaving them all highly vulnerable to official sanctions (Goodman 1998).

¹⁵Certainly not in that part of China where the interviews were held. The picture looks somewhat differently in the South and in the Chinese Overseas Communities, Seagrave 1995.

¹⁶In the province where the empirical research was undertaken (Shanxi) neither the managers or (commercial) entrepreneurs nor the local cadres had followed the One-Child-Policy, thus leaving them all highly vulnerable to official sanctions (Goodman 1999).

¹⁷Certainly not in that part of China where the interviews were held. The picture looks somewhat different in the South and in Chinese Overseas Communities, Seagrave 1995.

The empirical research provided almost no examples of firms established with investment from family members. TVEs, (real) private companies or the so-called joint-ventures where private capital is linked to public funds all grew out of a pooling of capital, labour and ideas amongst *friends*: people intimately known from childhood, school times or the workplace.

The interviews further show that the successful companies never move in only one network. On the contrary, entrepreneurship in China appears characterised by the ability and skill to carefully select network-connections for specific purposes. The question of qualified labour and marketing can serve as an illustration: In both cases new firms face heavy labour market restrictions, as well as regulation when it comes to extending beyond the village or county boundary. These restrictions can be overcome with the help of networks: the two most frequently employed are the People's Liberation Army with its large pool of technicians and engineers and the "alumni clubs with Chinese characteristics", classmates from colleges and universities. An individual firm would turn to former classmates or fellow soldiers when manpower is needed or when the firm plans to expand by establishing subsidiaries or retail outlets in other provinces, assuming that their networks would offer lower screening costs (in the former case) or monitoring costs (in the latter case).

With hindsight it is not hard to see why networks based on former classmates or fellow members of the PLA are so popular in this regard. Unlike the extended family which is (still) found concentrated in one place, both networks offer access to a larger market, as both are built on institutions (the PLA and universities) where people from all over China meet. These networks have their own unwritten statutes or *codes of honour*, and differ with respect to their ability to enforce them. Very much unlike what we observe in Russia, the Chinese did not get stuck with a "Mafia"-kind of economic structure. Instead Chinese firms selectively employ different networks, or change networks according to changing needs with the result that it is hard to find any networks in a local monopoly position. These networks (*wangluo*) ought not to be confused with "personal connections" (*guanxi*) in the sense that the latter helps to "bend the law". The transaction cost advantage of these networks is demonstrated whenever they can operate legally, and whenever these networks compete with each other. The exception proves the point: in the state sector individual firms face a

monopoly in the form of state bureaucracy which executes encompassing control over the input and output-market, foreign trade, prices, and investment. In other words, the use of private networks is forbidden, and therefore competition between different networks is rare. Networking here takes the form of clandestine red-tape operations. Unsurprisingly, state industry in China is as inefficient as in Russia.

On the other hand, whenever private exchange is allowed, private networks will emerge. A preliminary, rough rule of thumb reads as follows: the decisive network for resource allocation is the village, and whenever the village economy expands beyond its natural boundaries "national" networks, such as the PLA, the colleges, or the communities of villagers living in big cities, become effective. While all these networks co-ordinate the use of resources, the network of local and provincial party-state cadres is decisive for legislation and taxation. The foreign trade sector, in turn, depends on networks of party-state cadres with respect to legislation, and on the networks of villagers (or those from the same county) living abroad with respect to the acquirement of necessary international market information.

2. *Mutual dependency: political and commercial entrepreneurs*

In any authoritarian state and certainly in China, where the Chinese Communist Party is still determined to control social (as opposed to economic) development, any kind of privately organised collective action by which the needed public goods could be provided is a very risky endeavour. Therefore, an analysis would expect an underprovision of, in particular, those public goods, such as legislation and law enforcement, which run counter to the self-interest of the Party (Qian/Roland 1998). After all, the CCP has changed during the last twenty years only to the extent that *rule by law* is accepted, but without a *rule of law* (Benewick 1998). Yet both investment behaviour and the quick expansion of private exchange relations indicate that Chinese economic agents behave *as if* there were institutions which provide contractual security and private property rights protection. The solution to this paradox is to be found in the decentralised structure of the Chinese State, which is characterised by an increasing degree of local self-government. Two factors can explain this:

changes in national policy and the establishment of *mutual dependence* within the village economy.

The "state" in China stops at the county-level. This is a policy with a long history. More to the point, however, is the fact that after the failure of the Great Leap Forward even Mao Zedong respected the "autonomy" of villages, very much unlike Stalin. The reforms, in particular the new state Constitution of 1982 and the financial reforms of 1984 reinforced this notion:

1. The village is the (initial) *possessor*, if not owner, of all assets within its boundaries, such as land or capital goods as long as these are not part of industry directly under the control of central ministries;
2. Since 1984 the villages can no longer compete for shares of provincial or national budgets, but have to rely on self-generated revenues. At the same time they have gained sole responsibility for providing workplaces. Again firms in the state sector form the exception: these firms are directly controlled by Beijing.
3. The career chances of local cadres are closely linked to their ability to show *good governance* in the villages. Performance is measured in terms of workplace creation, and in terms of investment in infrastructure financed by local resources. The one-child policy is an exception to the rule that good governance stands for economic growth.

These changes in policy had the following effects on the political market in China: First, villages have considerable leeway for designing a *jurisdiction* in terms of tax legislation, regulation and other incentives that might help, or otherwise stimulate private entrepreneurship within their boundaries. Moreover, since the state no longer offers a bail-out guarantee for bankrupt local industry, which means that the village is faced with a hard budget constraint, the village budget and individual career chances have come to depend

¹⁸ As usual: two thousand years old.

upon the ability of the village leadership to *cultivate* a reliable and stable *tax-base*. In short, *the reforms destroyed the possibility to appropriate bureaucratic rents via competition for budget shares. On the other hand, the reforms opened opportunities to profit from institutional rents when and if institutional reforms caused taxable private entrepreneurship* (Nee 1989; Nee and Su 1990; Krug 1997b).

Village leadership and the village have common interests, which in most cases lead to the discernible dynamics in the establishment of new firms. Chinese entrepreneurs - both entrepreneurs from TVE's and private entrepreneurs in the (Western) legal sense - actively seek ways to make the village leadership "partners" in their business. This can take the form of establishing 'mixed' firms in which an individual entrepreneur and the village leadership pool capital - private savings from the former, and public funds from the latter - or of individual bidding for lease contracts by which an individual agent becomes the manager of local industry. In these ways the village leadership obtains a stake in the company. Its involvement is seen as a *credible commitment* with the consequence that mutual dependence actually increases. While this would be regarded as a straightjacket for action in a market economy, in the case of China it means additional incentives for the local political leadership to design a favourable mix of legislation and taxation. After all, it is the political leadership, and in this case certainly the party secretaries, who are, aside from designing local taxes and providing local infrastructure, needed for defence against provincial or national taxation and regulation. In other words, the value of a co-operative strategy outweighs the risk of confiscation.

As opposed to common interest, mutual dependence emerges from the co-operation-specific investment of the village leadership and the private agency of the firm. In order to understand the form of co-operation specific investment one has to acknowledge how decisive the build-up of social - as opposed to financial - capital is in the case of firms working within emerging markets. Unlike private individual village members who contribute to the joint-owned resource in form of savings, labour, or ideas, the local leadership's contribution takes the form of *social capital*. This social capital is based on their official

position in the formal and informal networks of the state and party administration, yet remains "embedded" in individual cadres or collective groups of cadres.

Co-operation between firms and local officials thus allows firms - or any other economic agent - to mobilise the cadres' social capital to their own purposes. In turn local cadres have an incentive to cultivate those networks because such an investment promises higher returns in form of local revenues. From the local economy's point of view access to these networks determines the firm's "positioning" in the market. It needs to be emphasised that factor endowment, let alone the ability to create (Schumpeterian) monopolistic niches, is less important to the economic performance of a firm than access to those networks which determine the degree of state interference, regulation, and taxation. In other words, access to official networks is a special kind of social capital, which determines the comparative advantage of a firm.

If local cadres provide social capital and do so through co-operation-specific investment, then one could expect that they are in an appropriate position to influence profit. Instead of confiscation, firms are more likely to experience "hold-ups". Once more Organisation Theory can explain the limits to such hold-ups, or, more to the point, why we find different levels of hold-ups and restraint across China.

3. *Governing "mutual dependency"*

The literature (for example Nooteboom et al. 1997) suggests two factors which limit the relational risk involved in cases of mutual dependence: differences in sunk costs and contracting.

Sunk Costs

Hold-ups occur not only if one party has a relation-specific investment and the other does not. They are also determined by the difference in sunk costs. In the case of China the sunk costs for local cadres, individually and collectively are higher than the relation-specific

investment for private economic actors. This has to do with the immobility (non-transferability) of both the social capital invested and the form of payment a bribe-taking cadre can expect. This assumption needs some clarification:

First, the social capital of local cadres rests on their position within the party-state bureaucracy in a specific location. Any opportunistic behaviour detected (even if unpunished) leads to a deterioration in the value of their social capital. Even if a bribe-taking cadre were paid in cash and could run away, the social capital which is connected to knowing people in the administration in one place would be forfeited. An economic analysis would expect hold-ups or individual bribe-taking to be higher whenever social capital is not geographically-bound. This is, indeed what we observe in the state-sector, in which one ministry controls one industrial sector. In this case, to take the money and run is an option since the connections which have been built up, for example in Beijing, do not so dramatically lose their usefulness when the cadre in question has moved to Canton, or to Hong Kong for that matter.

Second, hold-ups and individual bribe-taking depend on the returns for such behaviour. Due to the nascent market situation, bribes in China most frequently take the form of *consumption on the spot*. According to one nation-wide study (FEER Dec. 3, 1998) most monetary bribes do not go beyond US\$50. By far the most frequently employed forms of remuneration are visits to Karaoke-bars and dinners. In other words, even if hold-ups or individual bribe-taking were possible, individuals find it hard to accumulate private savings, which would allow them or their family to build up additional sources of income in the same village or indeed somewhere else. The non-monetary forms of bribes would then suggest that the level of corruption depends on the monetarization of an economy. Indeed, the more commercialised parts of China with access to cash-carrying foreigners report more corruption. Corruption depends on transaction costs rather than on the more traditional values of hinterland-cadres, let alone the contaminating influence of capitalism. The non-transferability of social capital and bribes constitutes the high sunk costs for cadres. Though undoubtedly private economic actors will also see their social capital deteriorating in case of

default, a greater part of their capital is in the form of monetary funds and human capital, both of which can be transferred to other places.

If a village does not want to face the risk that private capital goes elsewhere, it has to offer guarantees to private investment. It does so by offering property rights protection, contractual security, and the articulation of corresponding law enforcement agencies. It does so willingly or when forced by foregoing moral hazard.

Common law

As both the findings of the analysis of JOR and mutual dependence suggest, the Chinese economy did indeed embark on building those institutions which could help to mitigate the relational risk. Two features stand out: there was first the revival of *contracting* as the means for "hardening" binding agreements. The dominant feature is the form of crop-sharing contracts (Cheung 1969) which split the risk (and innovation rent) between the leadership and private economic agents. Moreover, crop-sharing contracts dominate also in private exchange contracts amongst firms within the village boundaries and between village companies and suppliers or customers elsewhere. It is easy to argue that crop-sharing contracts support the argument that Chinese culture is behind the extra-ordinary economic development. After all, if there had not been a traditional land lease system, which developed crop-sharing contracts, St. Cheung would not have looked into the matter. However, such an argument really only demonstrates that the Chinese had a comparative advantage in that they had experienced two thousand years of private property rights (in land) and fifteen hundred years of experience with legal contracting, so that both "traditions" could be remembered. Such arguments cannot explain why the Chinese chose to revive these and no other traditions. As opposed to the cultural argument, an economic analysis claims that those traditions, which promise economic returns - amongst other things - will be revived.

Secondly, certainly one of the most exciting features of institution building in China is the fact that, starting in the middle of the eighties and unnoticed, let alone approved, by the central government, villages began to design so-called *village compacts*, village constitutions which established procedural law and law enforcement agencies outside the party-state machinery. An analysis of these constitutions shows¹⁹ that protection of assets, contracts, and transactions are dominant concerns, with once again the exception of the one-child policy. Here, the problem of credible commitment once again needed to be solved. The village solution was more participation and more democracy at the local level (see also Tyler 1990 and Ostrom 1990).

Local level political reform has included not only remarkably free elections where the voters can choose between a range of party and non-party members, but also so-called *ethic committees* which come close to law enforcement agencies and "courts" with a jury system not unlike the Anglo-Saxon tradition in which members are elected by the village. It is worth emphasising that it took the national government in Beijing something like five to seven years to notice what was happening in the villages, and by that time the economic value of such a system was already so established that the Beijing leadership could not remove them. It is particularly the case that the economic value of local self-government and free elections is seen in their effectiveness when it comes to "combating corruption". For this reason alone, local self-government is tolerated.²⁰

Democracy is instrumental, nothing more. It is this instrumentality which creates a country with two political systems: a rural population enjoying some basic political rights, and an urban population which is denied those rights as in the cities the state claims that other means to fight corruption are more effective. This is correct whenever the city economy is dominated by centrally-controlled state-owned firms headed by ministries whose leaders cannot be voted out of office in local elections.

¹⁹ See Zhongguo Nongcun Cunming Ziyoushidi Yanjiuzu 1994.

²⁰ See International Herald Tribune Jan. 27th, 1999.

Today the rural form of *grass-root* democracy is acknowledged. Free elections are promoted, 60% of the villages held their second round of elections in 1998.

V. Constitution building by good practice: The challenge for further research

It is argued here that in the special circumstances of the Chinese economy at the beginning of the reform era, mutual dependence and village ownership over resources were blessings in disguise. While the political leadership advocated an institutional design to ensure that the state, albeit at the local level, would control economic and social development if it had a stake in local industry, the unintended consequence was that village leadership turned "entrepreneurial": it offered property rights protection, contractual security, rule by law, and law enforcement, all of which were much-needed public goods. Ultimately, in order to overcome the credible commitment problem the village leadership had to offer participation, government accountability, and free elections.

Competition kept rent-seeking at the local level at a very low rate, especially amongst local governments and between local governments and social networks. Ultimately too there is competition between self-regulated community production, networks and the nascent markets. It is this kind of institutional competition which offers several alternative courses for firms and private economic agents, and explains why so many Chinese emphasise the "liberating" effect of the reforms. It is also remarkable that within these networks and within the village community new *common law* is written, and new customs and commercial practices develop as well as the entitlements for other "public goods". There is no "race to the bottom" from this jurisdictional competition because there is a broad social consensus to be found in the villages, and because it is the village - and not the state - which is responsible for social welfare.

To conclude from all this that China is on its way to democracy is, however, premature to say the least. It is a policy of accommodation rather than a policy based on democratic

convictions²¹. At the same time, the development of local self-government, which started in some villages and later accepted as nation-wide policy, shows that there is something like constitution building developing in China. Moreover, this constitution is based on good practice in the sense that those aspects of the new institutions which have proven to be "good" – that is in economic terms and "vote" attracting - have a chance to get the upper hand.

To sum up, economists should not rely on theories outside their competence, such as cultural approaches, in order to explain either the emergence of firms, or of a private sector, or subsequently overall economic development in China. Modern Organisation Theory has much to offer and can provide useful explanations. Linking Organisation Theory with approaches from New Institutional Economics promises additional insights, since in this way it is possible to endogenise the political process. As shown here such a procedure can explain some of the most striking features of the Chinese reforms:

1. the emergence of TVEs and their continued status as the "engine of growth and transformation";
2. the spread of economic growth beyond urban conglomerations;
3. the emergence and success of small- and middle scale industry;
4. the ability of Chinese firms to design and enforce binding agreements;
5. the relatively low and manageable level of corruption in China, when compared to the former socialist states in Europe;
6. China's start to political institution building despite the Communist Party's continued exercise of strict control over political life.

As ample of historical cases show (North 1998, 18), development depends on the shift from the alternative of state-tolerated extortion to the alternative of trading state-provided "protection and justice" for revenues (North 1998, 18). Local cadres face these same alternatives today. It is still undecided in which direction the whole country will go, in particular as the incentive structure for the "privatised" state-owned sector has still not been

²¹ Nee calls this local corporatism. Nee 1992.

decided upon. However, as the analysis shows, local cadres face often situations where it is more advantageous to opt for the second alternative.

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