Efficiency, Institutions, and
China's Great Transformation:
A Research Framework

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ABSTRACT

The development of China in the past 30 years poses a challenge to orthodox institutionalist theories of modern economic and social transformation. China has experienced impressive economic growth, but with supposedly “flawed” institutions. How then was economic growth achieved? Did institutions matter in bringing about China’s economic transformation, as institutionalist theories should have expected? If yes, how did they matter?

This paper develops a theoretical framework for an explanation of the China puzzle and an understanding of the institutional conditions and consequences of national growth and development in China. It broadens the scope of institutional analysis to account for institutional effects that conventional theories tend to overlook. This framework defines informal institutions as an essential part of the institutional setting, allowing an investigation of whether efficiency can be gained substantially through informal institutions in settings where formal institutions are ineffective or insufficient. In doing so, the paper builds measurements of economic efficiency and the quality of institutions, and designs a series of case studies that will be used to identify and test the effects of informal institutions.

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The role of institutions in large scale national economic and social transformations has been a subject of debate for social scientists for many decades. Karl Polanyi’s work on the rise and fall of the political and economic order in the “North Atlantic Community” of the nineteenth century (Polanyi 1944), Douglas North and Robert Thomas’s work on the rise of the “Western world” (North and Thomas 1973), and Mancur Olson’s theory on the rise and fall of “nations” (Olson 1982) have set the general parameters for later research. Polanyi noted four key “institutions” behind nineteenth century prosperity and civilization: a balance-of-power system among the Great Powers, the international gold standard for the unique organization of the world economy, the self-regulating market that produced “unheard-of material welfare,” and the liberal state (Polanyi 1957: 3). Among these four institutions, the self-regulating market is considered to be “the fount and matrix of the system… which gave rise to a specific civilization” (Polanyi 1957: 3). Polanyi’s insight into the institutional foundation of Western civilization has pioneered a significant research “paradigm” on why and how nations rise and fall. A few decades later, in explaining the rise and fall of the great powers, Paul Kennedy concurred that it “was a combination of economic laissez faire, political and military pluralism, and intellectual liberty… which had been in constant interaction to produce ‘the European miracle’” (Kennedy 1987: 30), while the Ming Dynasty of China and the Muslim world declined.

North and Thomas’s view of Western civilization is somewhat broader – not just confined to the West of the nineteenth century – and their claims make the underlying assumptions of the analytical tradition more explicit. They argue it was efficient economic organization that separated the successful growth stories of Holland and England from the failures of Spain and France in the sixteenth and seventeenth century. North and Thomas show that inefficient institutions keep apart private and
social rates of return and therefore provide no incentives for individuals to engage in economic activities that could contribute to the collective good while pursuing their private interests. Those adopting an efficient economic system rose to prosperity and those developing an inefficient economic system declined. Here, we see the intellectual roots of the world wide modernization movement and campaign after World War II to “get institutions right” in developing countries.

Essential to this efficient economic organization is a clearly defined and enforceable set of property rights. For North and Thomas, there is always a gap between private and social rates of return in a modern economic system. Institutional arrangements therefore “create an incentive to channel individual economic effort into activities” (p. 1) that would bring the two rates close to parity (efficiency). Efficient institutions are therefore critical for the working of the modern capitalist economy.

However, Mancur Olson, echoing Karl Polanyi, takes a more sophisticated view. For Olson and Polanyi, an efficient economic system is not a strategic option that a country can choose, but rather a consequence of the interplay of the social, historical, and institutional dynamics of the time. Forces of economic and social integration and coherence in either direction, towards efficiency or inefficiency, coexist. Whether an economic system would emerge as an efficient one is contingent upon the interlay of these forces. For Olson, there is an inherent tendency for the social benefits of individuals’ activities to be devoiced from their private benefits. Organized groups and individuals may have different incentives for action because of the different effects of institutions on the individuals and groups, and their different capacities to shape institutions. Consequently, effective collective action tends to channel benefits to a small select number of groups. Moreover, those groups with vested interests will use political and legislative means to secure, monopolize and perpetuate these benefits. This group-based distribution of benefits tends to block the efficiency-prone interaction between private and social interests. Over time, the economy will lose efficiency and the nation will decline (Olson 1982. See also Knight 1982). Making a similar argument, Polanyi discussed the “double movement” in the nineteenth century where, on the one hand, there was the growth and expansion of the self-regulating market system, presumably an efficient economic system, and on the other hand, there was the reaction and resistance of those affected by the expanding self-regulating market. These reacting and resisting forces operated on a set of principles different from those of the self-regulating market system, which Polanyi summarised as the principles of “reciprocity, redistribution, or house-holding” (Polanyi 1957: 56). Polanyi sees the tension between these two sets of forces as the root cause of the “collapse” of the nineteenth century political and economic order in Europe.
The above brief review highlights three core propositions of the mainstream institutional theory about the role of institutions in modern national transformations. First, efficient economic organization is necessary for modern economic growth. Efficiency here is defined as parity between social and private rates of return from individuals’ economic activities. An economic system is efficient when activities of individuals in their private interest also contribute to the public good of society as a whole.

Second, institutions have to be built. It is part of human nature that individuals pursue their private individual interests first and foremost. There is no natural interest for them to keep their interests in line with those of the society. Whether their efforts would have the same positive return for the collective good will depend on various “constraining” and “motivating” factors, including, existing property rights, norms and customs of the society and kinship relations, the political structure and processes, and so on. Desirable social and collective outcomes, such as national development, would not naturally arise from individuals’ preferences and activities. Institutional arrangements therefore are needed. The rise of the modern state and indeed that of the modern capitalist economy is essentially such a process where efficiency-prone institutions emerged, formed or were imposed.

Third, not all institutions are efficiency-prone. There are good and bad institutions for a particular set of purposes, values, or interests. Pioneering research on the modern transformation of the West focuses on the establishment of property rights, laws, constitution, parliament, political parties, and electoral systems, as part of the institutional setting for the rise of modern capitalism. There is a consensus that institutions matter in economic and social development ((North 1990, Aoki 1997 and 2001, Keefer and Knack 1997, Knack and Keefer 1995, Clague 1997, Burki and Perry 1998). More precisely, there is a set of “best practice institutions” for modern economic and social development. These best practice institutions ensure efficiency, a liberal state, intellectual liberty and rule of law – the key elements of a liberal constitutional order.

The economic and social transformation of China of the past 30 years provides an ideal opportunity to test some of the key claims of institutionalist theories. Indeed, recent studies on China have documented the challenges that institutionalist theories face in explaining the role of institutions in China’s transformation (Brandt and Rawski 2008, Chen, Jefferson and Singh 1992, Woo 1999, Rawski 1999, Naughton 1996, Rozelle 1996, Lin, et al 2003; Lin 1989, Fan 1996, Sheng 1994). First, China’s transformation started when there was almost no separation between the public/social and the private/individual. China was a society where the private sphere had been institutionally, morally and politically eliminated. There was no private ownership,
and no constitutionally defined individual rights in property, politically or otherwise. The idea that modern transformation was driven essentially by interests and efforts of the emerging capitalist class to seek an institutional environment where the private interests are protected from the intrusion of state authority does not resonate with the reality in China. Indeed, it was the state’s determination to nurture private interests and the gradual emergence of private property and ownership that marked the beginning of China’s 30 year transformation.

Second, China’s rapid growth and development took place when institutions, or more specifically, efficiency-prone institutions, are said to have been weak, ineffective or mostly did not exist. Along with the expansion of the market, there has been a gradual expansion of efficiency-prone institutions. Even today, after 30 years of rapid economic growth and social development, the development of efficiency-prone institutions in China is still uneven and their quality still low. The parity premise of institutionalist theories therefore seems to be problematic. For institutionalists, “China’s remarkable combination of high-speed growth and deeply flawed institutions” (Brandt and Rawski 2008: 1) is a puzzle.

Third, there is growing evidence that the ways institutions formed, evolved and changed were “unconventional” and the ways they were deployed and provided “innovative” (Chen, Jefferson and Singh 1992, Lau, Qian and Roland 2000, Naughton 1995 and Zhang 2006 on dual track reform; Arthur 1994 on path dependence, Granovetter 1985 and Zhou 2002 on embeddedness of economic activity in society, Fan 1996, Sheng 1994, Rozelle 1996 and Lin, et al 2003 on gradualism and incremental reform; Ruttan 1978 and Lin 1989 on induced and imposed reform, Fan 1996 and Qian 2003 on Pareto maximizing reform, and Li 1996 on ambiguous property rights). Alongside the unconventional and innovative forms of institutional formation, evolution, change, deployment and provision, have been widespread corruption, prevalence of family and social networks in business and corporate management, great income gaps, and growing tensions among contested social values, traditional, modern or otherwise.

The challenge of the China puzzle to institutional theories is therefore twofold. The first challenge concerns the institution-efficiency link. If efficiency is essential for modern economic growth, has efficiency been achieved in China over the past 30 years? If yes, did institutions in China matter to that efficiency gain? The second set of questions centre on the institution-culture divide. If institutional arrangements underlying China’s 30 year economic and social change are not best practice institutions, not even institutions that institutional theorists would recognize, what are they? If patron-client relations, social networks and business ethics are related to individuals’ behaviours, are these behaviours shaped by some rules and constraints, as
well as incentives? If yes, are these rules part of the institutional setting, along with the property rights law, banking regulations, tax law, electoral system, party system, etc, that an individual responds to when they act? If yes, is there something missing in conventional institutionalist theories that focus primarily on the latter set of institutions?

This paper proposes a research framework with some rethinking of the notion of institutions that allows us to investigate these questions. The first section of the paper establishes the basic premise of the framework: that efficiency has been gained in China’s 30 year economic growth, but its institutions, those deemed necessary and essential for efficiency gain in conventional institutional theories, are found to be of low quality. Clearly, there is a large area of institutional effects that are unaccounted for here. The second part surveys theoretical attempts to explain the China puzzle and makes the case that much of the unaccounted effects are the function of what I call informal institutions and argues that institutions tend to be narrowly defined in conventional institutionalist theories and consequently their approaches tend to be state-centric, which makes them inadequate at explaining the China puzzle. The third part discusses the concept and logic of informal institutions, and why a broader concept of institutions is required for a fuller understanding of the institutional dynamics of China’s transformation. The fourth part proposes how informal institutions, as part of the institutional setting for China’s 30 year economic and social change, are identified and observed, and their effects on economic and social change analysed.

1. Efficiency and the quality of institutions: What’s wrong with China?

Conventional theories look at factors of production: land, labour, capital, as well as innovation and education, as determinants of economic growth. North and Thomas have dealt with this issue in their work and argued that these factors “are not causes of growth; they are growth.” To explain economic growth, they suggest, one needs to focus “on what causes economic growth. Growth will simply not occur unless the existing economic organization is efficient” (North and Thomas 1973: 2). There is clearly room for debate on their proposition itself, but our discussion will take the general premise of North and Thomas’ theory as the starting point. If empirically we can prove that China has achieved economic growth, then we could argue, on the basic premise of North and Thomas’ theory, that efficiency has been achieved in China; if the above is true, then, further along the logic of their theory, we can also argue that China should have good quality institutions. In this section, therefore, we establish whether efficiency has been achieved in China and what the quality of the
institutions in China during the 30 year transformation has been. In doing so, I put the China puzzle to an empirical test.

North and Thomas’ proposition defines the basic logic of institutionalist theories of economic growth: the causes for economic growth are to be found in the economic organization, that is, efficient economic organization is necessary for modern economic growth. Efficiency, in their view, leads to economic growth, and economic growth is a function of efficient economic organization. Furthermore, economic growth, as defined by North and Thomas, is “a per capita long-run rise in income.” “True economic growth,” according to them, “implies that the total income of society must increase more rapidly than population” (North and Thomas 1973: 1).

It is this long-run rise of per capita income that I use here to measure efficiency gains. We use Real Gross Domestic Income in PPP (RGDPITT) from Penn World Tables 6.2 (Heston, Summers, and Aten 2006) as the indicator of per capita income. PWT gives a true and internationally and historically comparable measurement of per capita income from 1950 to 2006, which sufficiently covers the period this study is interested in. As Figure 1 shows, there has been a “sustained rise” in per capita income over the past 30 years in China from the mid 1970s.

There have been great efforts in the development of measurements of the quality of institutions in relation to modern economic development and to governance in general (Knack and Keefer 1995 and 1997; Burki and Perry 1998, Campos 2000, Kaufmann, Kraay and Mastruzzi, 2008). These range from those very preliminary and indicative uses of the concept in early studies, including Karl Polanyi’s four institutions behind the 19th century European civilization, and Paul Kennedy’s three pillars supporting...
the European miracle, and North’s focus on property rights, to more recent attempts at a more systematic and scientific measurement of the quality of institutions. Notably among the latter are the World Bank’s *Worldwide Governance Indicators* (WGI), *Economic Freedom of the World* by the Economic Freedom Network (EFI Index), and the *Global Competitiveness Index* by the World Economic Forum (GCI).

The WGI (World Bank Institute 2008) is the most comprehensive measurement of the quality of institutions over a considerably long period of time. The WGI data covers the period from 1996 to 2007. It does not give us a measurement of the quality of institutions in the early years of China’s 30-year transformation. But given the nature of our enquiry, indicators from the mid-1990s should provide sufficient evidence of the quality of China’s institutions for the 30-year period with which we are concerned, as we assume quality in the earlier years can only have been worse. The six sets of aggregate indicators, “drawn from 35 separate data sources constructed by 32 different survey institutes, think tanks, non-governmental organizations, and international organizations,” measure six dimensions of the quality of governance, defined as the institutions and processes by which “governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them” (World Bank Institute 2008).

The EFI (Gwartney and Lawson 2008) is part of the WGI, but is used here on its own for two reasons. First, its data starts from 1970 which gives a better measurement of the historical change of the quality of institutions. Second, the index, particularly its Area II indicators – *Legal Structure and Security of Property Rights*, measures the “extent to which rightly acquired property is protected and individuals are engaged in voluntary transactions” (Economic Freedom Network 2008). Given the central thrust of North’s argument on the rise of the West, this indicator is significant.

The GCI measures competitiveness in a set of “institutions, policies, and factors that determine the level of productivity of a country.”¹ A key component of the “12 pillar” index, which is used here, measures institutions broadly defined as both legal and government institutions in the public sector as well as private sector institutions.

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¹ The survey is clearly framed by the institutionalist assumption of the causal relations between institutions and prosperity. The authors further explain that the level of productivity “sets the sustainable level of prosperity that can be earned by an economy. In other words, more competitive economies tend to be able to produce higher levels of income for their citizens. The productivity level also determines the rates of return obtained by investments in an economy. Because the rates of return are the fundamental drivers of the growth rates of the economy, a more competitive economy is one that is likely to grow faster over the medium to long run” (Schwab and Porter 2008: 1).
Figure 2 presents the WGI data on China as an indication of the quality of institutions in China over the 10 year period from the mid-1990s to mid-2000s. Of the six general categories of indicators, the indicators on voice and accountability are expectedly very low, moving around the average of -1.53 on the scale of 2.5 to – 2.5 with 2.5 being the highest quality. The best category is “government effectiveness.” Even this was around the neutral bar with an average of -0.02 over the 10 years. Indicators in all the other categories were below the neutral level.

The EFI data is plotted on Figure 3. The two data lines are the overall measure of all five EFI areas (1) and the index on Area II: legal structure and security of property rights (2). China’s indicators (orange) are compared with the world average (green). In terms of the overall measurement, China (5.55) is constantly around 1 point lower than the world average (6.16) on the scale of 0 to 10. For indicators on legal structure and security of property rights, China started higher but moved below the world average and then the two converged towards the end. Do note the comparison here is with the world average rather than the usual benchmark of countries in more advanced stages of development. In other words, the quality of China’s institutions has been lower than the world average for the past 30 years and far below countries in
more advanced stages of development. The data on the legal structure raises more questions than it answers. It is hard to argue that legal structure and the security of property rights in China were much better in the 1980s than in the 1990s, because, for one thing, there was no private property ownership in the earlier times in the first place. It is also hard to argue that legal structure and the security of property rights were getting worse in the 1990s. But one conclusion from the data is clear: that the quality of China’s institutions of legal structure and property rights was lower than the world average for much of the period.

Finally, Figure 4 with data from the *Global Competitiveness Report* 2008/9 provides another measurement of the quality of institutions. As of 2008, most of the institutions deemed necessary for economic growth are considered in the report to be a “disadvantage,” i.e. non-competitive, insufficient, or low quality, in the case of China. Of the 18 sets of institutions, from property rights to judicial independence, only one, the burden of government regulation, was considered to be favourable for China. China typically stands lower than average in ranking on these individual indicators.
From the above, we can draw several conclusions. First, the quality of institutions in China, those considered necessary for economic growth in conventional institutional theories, has been below the world average. The WGI gives more consistent evidence of this for the period from the mid 1990s. The EFI evidence runs from 1980 onwards. The GCI confirmed this as of 2008/2009. Second, evidence varies as to whether the quality of institutions has improved over the years. The WGI suggests that the quality has been quite steady while the EFI's data at two different levels give conflicting evidence.

Overall, the evidence here provides empirical support for the premise of the China puzzle: economic growth has been achieved and thus economic efficiency is assumed to exist while the provision of institutions for economic growth has been insufficient and the quality of institutions generally low. While we assume the quality of institutions has improved over the period, along with progress in reform and
development, we do not have enough data to claim how the quality level has moved over the 30 year period.

2. The China puzzle and Alternative Theories

The China puzzle raises difficult questions for conventional institutional theories on the conditions and consequences of modern economic and social change. There are opposing views in the general debate on what we should make of the China phenomenon. On the one hand, there is a persistent view that sees the China puzzle as a strange marriage between “economic freedom and political repression” that is fundamentally wrong and cannot be sustained (Callick 2007 and Pei 2006). On the other hand, there are scholars going beyond recognizing the uniqueness of China’s experience and seeing it as a distinct model of growth and development (e.g. Pan 2009, CCGA 2008). Our survey here however focuses on how the China puzzle is debated in institutional analysis. As debate on the fact of China’s economic growth and social development has been largely settled, much of the scholarly attention now focuses on the nature of institutions in China. This first and foremost concerns the political institutions. China’s party-state, non-competitive party and electoral system, the intrusive and interventionist state, and problems in accountability, transparency and civil participation are all cited as evidence of the low quality of institutions. One school of thought argues these problematic institutions are actually aspects of a different type of state and have been an important part of the institutional setting. Yao Yang, for example, uses the concept of “encompassing government,” coined by Mancur Olson in his last book (Olson and Cadwell 2000), and argues that the Chinese state is an encompassing state and its interests coincide with the society at large (Yao 2008). This is the basis for efficiency. Fan Gang, a leading Chinese economist, concurs with Yao’s view and points out that China is historically a centralized state. As such, there must be balancing mechanisms at the state level for diverse regional and local interests. As the ruling regime is not subject to periodical changes, the long term aims of the state can be ensured (Fan 2008).

According to them, in the language of neo-institutionalism, the China puzzle vindicates a more “efficient” political organization of economic activities. Predicable political stability provides an overall setting for low cost and more effective interest articulation and satisfaction. The dominance of single political force in such a political order is capable of imposing perceived collective interests over competitive groups and sectoral interests and therefore further reduces transaction costs.

Xi Tianyang goes back to the original Coase Theorem (Coase 19560) to explain a possible different way of understanding the role of government in institutional change. In his view, a defining proposition of the Corse Theorem is that clearly defined
property rights are essential for market transactions, a principal view that underlies the work of institutional theorists. It is the clearly defined property rights that make efficiency optimization possible. If, Xi goes further, we take the Coase Theorem and apply it to society at large, the maximization of the overall welfare of a society has to be built on a broad range of clearly defined rights of individuals and groups including property rights (Xi 2007: 22) and the task of “designing and formulating of various rights including property rights” falls naturally in the hands of the state. Conventional institutional theories are therefore essentially state-centric. The institutions most prominent in their studies are mostly formal institutions designed, formulated and enforced by the state.

Moreover, the state not only has a responsibility to design and formulate institutions and define private rights, there are also areas where the ownership and boundary of property cannot be clearly defined because of technical difficulties, legal costs, and claims of public interests. These properties are “allowed to be kept in the public domain,” (Barzel 1989: 62). This is a large area where, if the overall political system allows, the state can exert a significant influence in shaping property relationships. The much debated phenomenon of ambiguous property rights in China’s reform reveals that the ambiguity in property rights may be seen as problematic in terms of institutional quality. But it is in this ambiguous, informal institutional setting that efficiency was better gained (Li 1995).

To recognize the unique role of the state in the formation of institutional setting is only one way to explain the China puzzle. Others offer very different explanations. For some, the problem lies in the state centric approach to institutions in conventional institutional theory. They argue that institutions are not solely driven by the neutral public authority, i.e. the state, imposing efficiency prone rules on firms and individuals. Indeed, the state is not necessarily a neutral third party that worries primarily about efficiency and collective interests. It is rather a platform where various interests and forces within society seek dominance. Institutions reflect the balance among the different interests of social forces and their varied capacities to bring their interests to bear on the institutional setting.

This conception of the state’s interest as an aggregation of private interests and institutions as a “Nash equilibrium” (Aoki 2008: 115) of these interests goes back to the public choice theory of James Buchanan and Gordon Tullock in which they argue that the public interest that is perceived to be represented by the state in traditional political theory is no more than a reflection of the prevalent balance of the interests of individuals and groups who have different capacities to influence the shaping of public interest and public policy (Buchanan and Tullock. 1962). Works of Andrew Schotter (1981), H. Peyton Young(1998), Jack Knight (1982) and Olson (1965) all
depict the formation of institutions as a bottom up, bargaining process in which
individuals or groups form or shape the formation of institutions to maximize their
interests.

In applying public choice theory to the Chinese case, Gang Fan dismisses the debate
on whether China’s transformation is endogenous or exogenous (Lin 1989) as
misleading. For Fan, the state is simply one of the players in the economy, rather than
an exogenous, neutral actor. It is part of the evolving, interactive, dynamic interplay
of interests and capacities of various forces in the shaping of institutions (Fan 1996: 6).
Ruilong Yang, making a similar argument in a slightly different way, takes on “the
North paradox” and argues that there is an inherent contradiction in the top down,
state centric approach to institutional provision: the state is expected to provide
institutions to maximise efficiency but it also has a natural tendency to monopolise
rents.

Seeing “the state in society” or institutional development as a “bargaining game,”
has important implications for understanding the China puzzle. It first allows us to see
institutional development not solely or primarily from the point of view of design,
implementation and enforcement by the state, but also as a consequence of the
interplay of dominant interests in society. The dual track arrangements that dominated
the institutional setting for China’s 30 year transition were a good example where old
institutions and new institutions coexisted. This coexistence reflects what Qian
Yongyi called the “two objectives” of institutional reform: “to improve economic
efficiency by unleashing the standard forces of incentives and competition on the one
hand, and to make the reform a win-win game and thus interest compatible for those
in power on the other,” (Qian 2003: 307). This latter objective suggests a broad
principle of institutional development: it is those who have capacity and power as
well as relevant interests that shape the formation of institutions. The dual track
arrangements were a “mechanism” that worked to satisfy conflicting interests of
people and achieve “Pareto improving” reform (Lau, Qian; and Roland 2000). In a
similar study, Justin Lin, Cai Fang and Li Zhou argue that the fair market conditions,
rather than ideally designed and state-sanctioned property rights underlay the
“Chinese miracle” (Justin Yifu, Cai Fang, and Li Zhou 2003 and Lin 1995).

This more pluralist approach to institutions also allows us to understand that
institutions can be transitional, as part of a process in which preliminary forms and
temporary arrangements evolve into formal institutions. Qian in his aforementioned
work criticized the “naive perspectives of institutions” that see only good institutions
and bad institutions (Qian 2003: 306). In Qian’s view, there are many transitional
points where institutions temporarily form to satisfy the conditions and interests of the
time. Institutions at these points are temporary, ad hoc, and perhaps in a tradition
eventually towards “best practice institutions.” The institutions that have been driving China’s economic and social change are not “best practice institutions,” but rather “best working institutions.” They are transitional in nature, satisfying different conditions of different times and eventually will develop into “best practice institutions” in the end. The China puzzle, according to Qian, is not a puzzle at all. It reflects the subtle nature of institutional change “that there will be a time period in which impressive growth does not require perfect institutions, and imperfect but sensible institutions can perform” (Qian 2003: 331). It is naive for both the orthodox institutional theorists and the Beijing consensus enthusiasts to argue over whether the institutions in action behind China’s miracle economic performance are “best practice,” as they all confuse the goal of the best practice institutions and the process toward that goal where institutions are imperfect, ad hoc and transitional.

In his three-stage model of institutional change Ruilong Yang (1998) makes a case that institutional provision in the initial stage of China’s reform was dominated by the state-centric approach where the state “designed and implemented institutional innovation exclusively through executive orders, laws, regulations as well as policy incentives with the aid of the top-down administrative system” (1998:3-4). This failure in the early stage of economic reform was followed by a more successful second stage where institutions emerged significantly “from below” through collective action by political, economic and educational groups (1998:4) - a process of “spontaneous order” as envisaged in Hayek’s work (Hayek 1960). In what Yang called “the middle-layer expansion model of institutional change,” firms, interest groups and local government were much more active and effective in effecting institutional change. This model is different from the third model that is expected to emerge along with further economic, social and political development where individuals’ rights and opportunities to participate in the political process and institutional formation are fully established and individuals’ direct input on the state for institutional provision becomes possible, a model Yang calls the model of bottom-up induced institutional change.

The pluralist approach also sees the formation and evolution of institutions as a dynamic process where institutions evolve out of cultural traditions, customs, norms, and practices. There is significant interest among those scholars of institutional analysis in the work of Avner Greif (1994, 2006). Essential to Greif’s study is how cultural traditions affect people’s institutional choice and shape the organization of society. Weisen Li (2001, Chapter 7, 2004: Part III), however, goes further and traces scholarly interest in the role of culture and customs in the formation of institutions and social order much earlier to the work of Max Weber (1978) and Fredrick A. Hayek (1960). Li argues that in the work of both Weber and Hayek, there is
recognition of the logical, evolutionary link between institutions on the one hand, and customs and conventions on the other. In the case of China, Chinese traditional society was built on the primacy of norms, values, rituals and customs over law. Confucianism had been prominent while Legalism never gained predominance in Chinese history. There is significant intellectual and historical support for taking cultural traditions, customs, norms and conventions seriously as an integral part of an institutional setting and seeing their relationships with formal institutions as dynamic, interactive, and evolutionary.

Finally, the Chinese experience also raises questions about the assertion that the quality of Chinese institutions is low. For some, the qualitative judgement is misleading and is what is wrong with the state centric approach that emphasizes institutional design and implementation through the state process. In reality, the formation and evolution of institutions is much more subtle and complicated. What matters here is not what institutions you have, but rather what these institutions do. If the essential purpose of institutions is to enhance efficiency, then those that emerge and contribute to efficiency are good quality institutions. David Li, for example, raised this issue in his study of the role of ambiguous property rights in “the highly successful emergent non-state sector” (Li 1996). In his study, Li found that “ambiguous property rights arise due to an imperfect market environment…” and “the immature market environment in China makes ambiguous property rights often more efficient than unambiguously defined private property rights,” (Li 1996: 1). The Chinese experience, Li states, seems to have constituted a major contradiction to the conventional wisdom on property rights” (Li 1996: 2).

The above summary suggests that orthodox institutionalist theory faces an insurmountable difficulty in explaining the China puzzle. Institutional analysis has since developed various new perspectives and methodological models to deal with the problem, with the aid of public choice theory, game theory, and cultural theory. Those working on the case of institutional formation and change in China’s 30 year reform in particular incorporated these new perspectives and theories, and engaged and introduced to us the rich, and challenging empirical evidence of the Chinese experience. Their work has formed a growing field of significant theoretical innovation and empirical richness in institutional analysis. Their contribution to institutional analysis can be summarised as follows. First, institutional formation and change can be a top down, state dominant, and formal institutions focused process. However, we need to have more attention to the bottom up process driven by group interest where institutions are not only constraints on members of society but also arrangements of compromise, accommodation and incentive. Second, while state sanctioned formal institutions are important, they are not the only institutions that
bear on economic development, political organization and social order. In an institutional setting where state institutions lack credibility or effectiveness, other institutional arrangements can play a significant role. Third, institutions can be good or bad for particular values and purposes. But in a complex social, cultural and historical environment, institutions are constantly evolving and adjusting, reflecting changing interests and varied capacities in society. Consequently, the purposes and values that institutions serve may not be always clear. Institutions can be dynamic, transitional or ambiguous which defy simplistic value judgement.

While existing studies on China reveal problems in conventional institutionalist theories, the exact role that institutions have played in China’s transformation remain elusive. Scholarly attention has focused on explaining China’s uniqueness. However, our discussion above suggests that the China puzzle requires more than just a recognition of China’s uniqueness. The puzzle needs to be solved at the conceptual and theoretical level. What are different types of institutions? How do different types of institutions form, evolve and change? Why are some types of institution more prominent and more effective than others, and why are they more prominent and effective in some national and historical settings than others?

3. Informal institutions and the China Puzzle

In North’s definition, informal institutions are already included. Indeed, North uses a whole chapter to discuss “informal constraints” in his later work on institutions, institutional change and economic performance (1990: 36-46). Institutions, in his view, are “humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)” (North 1991: 97). The fact the institutions are seen as “constraints” raises the question of why individuals develop “informal institutions” to constrain themselves. The constraining effects of formal institutions are easy to understand as they are formed and sanctioned by a collective third party – the state which can impose constraints on individuals for the collective good. Informal institutions however are different. They develop, form, or emerge among individuals themselves. Some, for example norms of an ethnic group, may have a collective effect, but many others, for example, trust and social networks, do not. They are reciprocal relations among individuals. There are motivations or incentives for them to enter and maintain the special relationships. Broadly defined institutions therefore can have both constraining and motivating effects. While formal institutions tend to be rigid to be effective, informal institutions allow a greater level of flexibility for concerned parties. Seeing only constraining effects in informal institutions does not accurately reflect the
true nature of informal institutions. This is perhaps the reason why, in conventional institutional theories, informal institutions are recognized, but their effects are not usually accounted for.

A second issue with North’s definition is it does not recognize the fact institutional formation and evolution is a dynamic process. Relations and interaction become institutionalized for the benefits of the members of a group or population. Institutions at this stage are informal because they are civic and local, not sanctioned by the state; imperfect and ambiguous, reflecting evolving interests and compromises of the members, and transitional as they are temporary arrangements before the permanent arrangements can be formally established.

The rethinking of institutions suggested above allows a broader definition of institution that sees both formal and informal institutions as an integral part of the institutional setting that “structure political, economic and social interaction.” At the same time, formal and informal institutions are two different types of rules. Formal institutions are those rules and procedures formed through and enforced by the state and apply to everyone in the polity, while informal institutions are rules formed within a group or population as manifested in values, sanctions, traditions, norms, and social relations. These rules are effective mainly on members of the population. Informal institutions are also those in an early stage of institutional development. They are ad hoc, experimental, temporary and transitional.

Informal institutions in this broad definition can be seen as alternatives to formal institutions and as an option in an individual’s institutional choice. When formal institutions are ineffective, too rigid, too costly, or even non existent, informal institutions can be preferred by members to provide trust, credibility, certainty and security in their relationship and interaction. Social networks, business practices and methods of business dispute resolution are all good examples of informal institutions in this sense.

Informal institutions can also be seen as ones in the early stage of institutional evolution. Informal institutions therefore are imperfect in relation to best practice institutions; ad hoc as they are set up for the circumstances and conditions of the time; and experimental, as they are temporary arrangements confined to a local environment. Experimental arrangements are necessary so that new institutions can be tested within a controlled environment and the social consequences of their possible failure can be limited. Further improvements are possible before they are formally established at the national level, which reduces the cost of institutional building. The dual track arrangements and ambiguous property rights, two significant phenomena in China’s 30 year transformation, are examples of informal institutions in this sense.
Institutions are rules and relations of our making. The value and effectiveness of institutions is ultimately determined by how best they satisfy the interests of those who are parties to the rules and relationships. Institutions therefore are not only constraints but also incentives or motivations. Because of the different, diverse and often conflicting interests, intensions and values involved in the development of institutions, informal institutions are necessary temporary arrangements that satisfy the interests, intensions and values of the time to the extent that a particular set of new institutions can get sufficient support to continue to evolve.

Trust, social capital, cultural habits, social networks, family values and ideology have been the subject of study in different disciplines, such as sociology, marketing and business, and cultural studies. In the case of China itself, there has been for example a long scholarly tradition that tried to understand the role of social connections, networks, social capital, social values, and ideology in business, economic growth, social development and modernization (Pye 1985, and Bell and Hahm 2003 on Confucian authority; Hamilton 1996 and Hamilton and Gao 1990 on family based business; Gold, Guthrie and Wank 2002 and Langenberg 2007 on social connections and networks; Fukuyama 1996 and Hu 2007 on trust and social capital; Thornton 2007 on moral discipline). Most of these are generic research on the issue itself or as a part of Asian culture. Some of them (Hu 2007 and Gold, Guthrie and Wank 2002), start to either approach these matters as part of the institutional settings, or explore their relationship with formal institutions. On the other hand, scholars of institutional analysis are also expending their scope of research to include informal institutions in (Keefer and Knack 1997, Knack and Keefer 1995, Burki and Perry 1998). These are valuable works looking into areas that are clearly an important part of the institutional setting that conventional institutional theories tend to overlook. But if these “informal institutions” are part of an institutional explanation, the conceptual framework has never been laid clear as to how these “informal institutions” can be incorporated into institutional analysis and how the effects of informal institutions on economic growth can be investigated, measured and established as in the case of formal institutions.

and explore the unique Chinese “model” of institutional development and provision, the precise nature of the Chinese model in terms of institutional analysis is yet to be fully understood. These studies suggest a large area of institutional arrangements and effects that are clearly outside the scope of formal institutions.

The challenge of the China puzzle to conventional institutionalist theories is not so much how much the development and provision of institutions in China’s 30 year transformation has been complicated by the cultural and historical conditions in China. But rather it points to the conceptual and theoretical problems at the roots of institutionalist theories.

4. Effects of Informal Institutions on Economic Efficiency

In this section, we propose a method of investigating the effects of informal institutions on economic efficiency. We do this on the premise that economic efficiency has been achieved in China’s transformation as Section 1 has demonstrated. We argue further that efficiency can be gained substantially through informal institutions. If efficiency has been achieved while the quality of institutions has been low, something else must have been responsible for the efficiency gain and for rapid growth. The problem, in our view, lies in the definition of an institution. As we have shown in Section 1, existing studies focus mostly on the quality of formal institutions, using indicators such as government effectiveness, regulatory quality, rule of law and voice and accountability. But the discrepancy between the low quality of institutions in China and its successful growth and development suggests a large area of unaccounted-for institutional effects. We suspect these effects might be in large part the function of informal institutions.

To test this hypothesis, we design a series of focused case studies on the effects of informal institutions on efficiency. Informal institutions, as seen in our definition above, are civic (not formally sanctioned by the state), local (effective within a specific group or set of relationships), and transitional (imperfect or being in an early stage of institutional development in relation to best-practice institutions). There is a whole wide range of informal institutions that may have effects on efficiency. We have selected three representative sets of informal institutions here as they can best demonstrate the properties of informal relations, and they have played a significant and unique role in China’s 30-year transformation:

Case Study I focuses on social networks embodied in family connections, regional associations, overseas Chinese groupings, and patron-client relations among business people and government officials – institutions often considered to belong to the domain of “culture.” Social networks are institutions because they involve established
and ongoing relationships, stable and mutually understood interests and expectations on the part of the parties involved, as well as regular and reciprocal interaction among the parties. They are informal because they are not sanctioned by the state and effective primarily within a limited domain defined by the social network itself. An institutional analysis of social networks investigates how social networks have become preferred alternatives to formal institutions in economic activities and how they provided trust, credibility and certainty when formal institutions failed to do so. The case study shall investigate whether the prevalence of these informal institutions was due to the problems in formal institutions; and how these “cultural” phenomena in the eyes of conventional theories can be incorporated into institutional analysis.

Case Study II takes the problem of ambiguous property rights. Ambiguous property rights have been a unique phenomenon in institutional provisions in China. They are ad hoc, mixed-ownership relationships in private enterprises where the local government has some form of control in private firms. They also refer to the actual rights, not clearly defined in state law, of land users, such as farmers, or urban property owners. It has taken decades for private property rights to be formally recognized in state law. Even today, land rights still constitutionally belong to the state, while farmers and other property “owners” only have lease rights. The case study should consider the cases of farmers and their land rights, and ownership of township enterprises, and investigate how farmers and enterprise owners were motivated to actively participate in national growth activities through the arrangements of ambiguous property rights when formal legal institutions failed to provide clearly defined property rights for them. It shall further explore whether ambiguous property rights are (a) consequences of institutional choice over formal institutions which tend to be rigid and costly; or (b) compromises of different, conflicting interests involved in the development of the institutions; or a mixture of both.

Case Study III examines the dual track institutional arrangements of new institutional provisions. Dual track institutional arrangements refer to an institutional setting where old institutions and new institutions coexisted in the process of the formation and expansion of new institutions, such as those concerned with price mechanisms, tax, currency and resource allocation. Institutional arrangements that emerged in this process are informal as they are ad hoc, experimental, transitional and often possess no formal legal basis. This case study is expected to explore why new institutions were provided for in such informal fashion; whether a process from informal to formal institutions is necessary for institutional formation and provision; and, most importantly, whether informal institutions are an integral part of any institutional setting.
All three case studies investigate areas often marginalised or not accounted for in conventional institutionalist theory. They are designed to test our hypothesis that informal institutions account for a substantial range of institutional effects in China’s 30-year transformation. Informal institutions, we suggest, have provided preferred alternatives to formal institutions (Case Study I) as a consequence of the low quality of formal institutions. They have developed as a remedy to the lack of support expected from formal institutions. As temporary, ad hoc, transitional arrangements in the early stage of institutional development (Case Studies II and III), informal institutions are “the most appropriate” rather than “best practice” institutions. They are compromised arrangements promoting efficiency while at the same time reducing resistance to the continual development and expansion of the best-practice institutions. The primary purpose of these case studies is to understand how precisely these informal institutions existed, formed, and were effective means to “channel individual economic effort into activities” of national economic growth and development.

Conclusion

This paper has proposed an analytical framework for research on the role of informal institutions in China’s 30 year transformation. Conventional institutional theories are insufficient and inadequate in reorganizing, observing and analyzing the effects of a wider range of institutions and dynamics on their formation and change, beyond their state centric institutional frameworks. There are substantive studies in mainstream institutional analysis that offer alternative perspectives to how institutions form and change. There is a growing body of literature on China as to what types of institutions are prevalent, how institutions form and develop, and the unique characteristics of institutions in China. However, the exact role that institutions have played in China’s 30 year transformation remains elusive and the China puzzle persists. I have argued in this paper that the China puzzle can be more effectively dealt with at the theoretical and conceptual level in institutional analysis itself. This paper has discussed the China puzzle; various theoretical attempts for its explanation; and argued that part of the solution to the puzzle can be found in the problem of informal institutions. A broader concept of institution and a pluralist approach to institutions shall enable us to explain institutional effects unaccounted for in conventional theories and enhance the ability of institutional analysis to explain more complex processes of institutional formation, evolution and change in different national, historical and cultural settings. Much more substantive work is still needed. But this paper has provided I hope a useful framework for us to understand the problem and how we might be able to solve it.
REFERENCES


