



## ***Permanency and Flexibility of Institutions: The Role of Decentralization in Chinese Economic Reforms***

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**Abstract.** The purpose of this paper is to offer a Lachmannian analysis aimed at studying the coherence and the efficiency of reforms in China in terms of institutional change. The idea is that transition dynamics cannot be analyzed by reference to market criteria only; transition is, above all, a change in institutions. Every transition economy thus faces the problem of creating a new institutional framework which associates the co-ordination of activities by the market with the preservation of a centralized mechanism of resource allocation. We explain that, in China, this role is played by decentralization. Indeed, we demonstrate that Chinese economic reforms, of which the main institutional vector is decentralization, show the particularity of reconciling, within one single logic, the permanency of a well-established institutional order required for the co-ordination of individual plans, and the flexibility of institutions necessary for the move towards the market. We then defend the theory that both the success and the originality of Chinese economic reforms rest on their capacity to resolve the permanency-flexibility dilemma.

**Key Words:** institutional change, Chinese reforms, decentralization

**JEL classification:** P11, P30.

### **Introduction**

The Chinese reform is so particular that one sometimes speaks of the Chinese model of reform. This specificity has been explained by numerous analyses which insist on the smooth view of the reforms as opposed to the big bang approach (shock therapy). In this way, authors like Perkins (1994) or Liew (1995) use different arguments to discuss the *gradualism* thesis: whereas for the former, gradualism reveals all the obstacles that stand between the partially reformed Chinese economy of the early 1990s and a full market system, the latter considers that gradualism, at the opposite, is associated with a strong central state who is able alone to provide the favorable conditions to reform. In a very narrow perspective, Sing (1993) defends the idea of a *step by step* approach to Chinese reform, based on the notion of an optimal combination of market mechanisms and planning. Still in the same line of thought, Jin and Haynes (1997) use a *dualist and leading sectoral* approach to explain that China has used some leading sectors in order to help the emergence of new elements of the market economy while continuing to exploit the basic components of the old system, the whole contributing to the maintenance of a relative stability of the economic and social framework.<sup>1</sup> Finally, Fan (1994, 1996) characterizes the Chinese model of reforms as a *dual-track* transition model, thus underlining the rapid development of a new

system alongside the old one, the latter being momentarily preserved from any fundamental reforms.

Although such analyses help to characterize the Chinese model, they do not specifically take into account the institutional element of the reforms. Our thesis is however that the institutional element represents the key component in order to explain the coherence of the reforms in China. The purpose of this paper is, in this perspective, to offer a Lachmannian analysis aimed at studying the coherence and the efficiency of reforms in China in terms of institutional change. The idea is that transition dynamics cannot be analyzed by reference to market criteria only; transition is, above all, a major change in institutions. Every transition economy thus faces the problem of creating a new institutional framework which associates the co-ordination of activities by the market with the preservation of a centralized mechanism of resource allocation. We explain that, in China, this role is played by decentralization. Indeed we demonstrate that Chinese economic reforms, of which the main institutional vector is decentralization, show the particularity of reconciling, within one single logic, the permanency of a well-established institutional order required for the co-ordination of individual plans, and the flexibility of institutions necessary for the move towards the market. We then defend the theory that both the success and the originality of Chinese economic reforms rest on their capacity to resolve the permanency-flexibility dilemma.

The first section of this paper thus deals with the analysis of the relation between institutional change and economic reforms in the context of transition economies. An analytical framework which articulates the development of the market with the Plan is proposed. Our purpose here is to insist on the advantage of taking into account Lachmann's theory of institutional change (1970, 1979, 1994) in order to explain the complexity of Chinese economic changes.

The second section tries to evaluate the role of decentralization, considered as the main transmission vector of an institutional change, based more on an evolutionary logic than that of destruction-reconstruction.

## **1. Institutional Change and Economic Reforms: Understanding the Case of China**

In any explanation of economic development as well as of the differential performance of economies through time, the importance played by institutional change is hardly controversial (North 1990, Lin and Nugent 1995). Following this line of thought, a growing number of works are today underlining the role played by institutional changes in transition economies.<sup>2</sup> Most of these works are however based on a substitution logic (between different governance structures or institutional arrangements) which prevents to analyze the Chinese case which articulates—in a complementary logic—the coordination mechanisms of the Plan and the ones of the market. The following analytical framework should permit to go beyond this difficulty.

All concepts of social institutions relies basically on the notion of *rule-following behavior* (Langlois 1993:166): institutions exhibit a sort of regularity of behavior which can be understood in terms of rules, norms and routines (Nelson and Winter 1982). More precisely, following Schotter's view, it is possible to define a social institution as "a regularity

in social behavior that is agreed to by all members of society, specifies behavior in specific recurrent situations and is either self-policed or policed by some external authority” (1981:11).

The most basic function of institutions is to economize transaction costs: when the future is unforeseeable, expectations divergent and the dis-coordination forces as strong as those of co-ordination, social institutions may enter the picture in order to align expectations and, in doing so, to allow agents to improve their welfare. In other words, they provide “points of orientation” that are likely to make both actions and expectations relatively compatible (Lachmann 1970).<sup>3</sup> However, this does not mean that institutions are always the result of an *ex nihilo*—or legal—creation process. Institutions arise fundamentally because of the interactions of individuals: any practice that allows the attainment of individual goals will spread until it becomes an institution.

Institutions thus have a very ambiguous status: not only do institutions constitute an external framework that removes uncertainty from market transactions and consequently form the incentive structure of a society, they also appear to be internal to individual transactions, the latter leading to their adjustment and evolution. Any theory of economic change must consequently integrate the fact that, if economic change shapes the institutional evolution of the economy—in the sense that economic change is an incremental process resulting from the day-to-day choices of individuals actors,—it also reflects the opportunities provided by what North (1994) has called the institutional matrix.<sup>4</sup> In the case of a developed market economy, such a relationship between economic change and institutional change is no longer problematic, since institutional change may occur through gradual modifications, that is, by the alteration of prevailing institutions. This is not the case, however, for transition economies which, by definition, have chosen to reform their entire institutional framework.

Indeed, adopting an evolutionary reasoning, every process of economic transition must be seen as a very particular stage in which a new phase of a more market-oriented economy is emerging within an older planned system. The outcome is that any explanation of the transition process needs an analysis of how markets develop and evolve through time rather than of the requisites for a well-performed adoption of market mechanisms.

The institutional component is, in this perspective, destined to play a critical role. The idea is that the institutional framework which prevails at any one moment in one country is likely to help or to impede the transition process according to its ability to integrate (or not) new elements.

More precisely, every transition economy must face three inter-related kinds of problem.

Firstly, there is the problem of institutional change and how to reconcile the idea of an institutional change with an institution as “a point of orientation,” which assumes its fixity. Although this problem is not specific to transitional economies, it appears to be more blatant with regard to them. Indeed, in transition economies, the forces of change often lead to an asymmetry between the destruction and construction of institutions (Jin and Haynes 1997): the destruction of a planned system has proved much easier and more rapid than the construction and emergence of a new system of market economies.<sup>5</sup> Consequently, individuals are confronted, more or less durably, by a lack of rules in order to co-ordinate their plans, and the danger is that a too-rapid process of transition may shift the comparative advantage

of governance structures to Mafia-like organizations rather than to market institutions (Jin and Haynes 1997).<sup>6</sup>

Secondly, the issue of institutional order and its unity is formulated. Indeed, the routine courses of action that comprise institutions are not all independent. It is the complementarity of institutions that builds the institutional order of a society. In other words, if institutions are to serve as instruments of co-ordination, they must themselves be co-ordinated (Lachmann 1970). Analyzing the transition of a planned economy to a market-oriented economy thus requires that we specify the conditions for attaining the coherence of the institutional order,<sup>7</sup> whereas the parts of the system are evolving at divergent speeds. The efficiency criterion can hardly be used, since "inefficient" institutions may always persist due to factors such as path dependencies, technological irreversibilities, political resistance to change, etc.. Moreover, some inefficient institutions may contribute to reinforce the efficiency of efficient institutions.<sup>8</sup>

This complementarity/interconnectedness issue underlines all the contradictions that exist in the two competitive approaches of the transition process. While the problem of co-evolution in a system where parts are evolving in divergent speeds contradicts the big bang theory of a fast-radical-holistic transformation of the planned economy, the gradualism approach shows difficulties in answering the criticism that piecemeal reforms of one, or several, components of a planned economy will be nullified and distorted by other, interconnected components functioning within the old regimes (Ericson 1991, Murphy et al. 1992).

There is finally, and consequently, the matter of the rise of new institutions. Bringing a new institution into existence requires not only the existence of certain needs, but also what Lachmann called "the specific 'entrepreneurial' skill of the innovator, as well as that of his successful imitators" (Lachmann 1970:78). What is suggested here is that the adoption/transfer, as well as the creation of new-original institutions, is subject to delays, a delay of implementation in the first case, and secondly a delay of construction.<sup>9</sup> The degree of change possible per unit of time is limited; time appears to be the dimension in which the learning process of human beings constrains both the adoption and the creation of new institutions.

Such a constraint is, once again, stronger for transition economies. Let us consider the case of the adoption/transfer of market institutions by/in a planned economic system.<sup>10</sup> It is perhaps useful here to recall the distinction usually made by Austrian economists between the "legal norms" or "designed institutions" which are "the products of legislation and other manifestations of the 'social will'" (Lachmann 1970:69), and the "recurrent patterns of conduct which we call (...) undesigned institutions" (p. 75).<sup>11</sup> Then, if it is still possible in theory, as well as in practice, to conceive a situation in which a political authority decided to implement one, or several, market institutions, the benefits of such a policy would appear to be controversial. The main reason for this is that it is, by definition, limited to designed institutions and its success then depends on whether these new elements meet the demands of undesigned institutional changes. The difficulty lies in the fact that if changes in designed institutions are radical and possibly fast, modifications of undesigned institutions are incremental and necessarily path-dependent. Indeed, ignoring the fact that individuals strive to change the given rules when it pays for them to do so, their behaviors are

shaped by a collective cumulative learning, that is by a learning derived from the collective cumulative experience of past generations. Adoption of institutions does not necessarily signify their institutionalization.

The most obvious implication is that transferring the formal economic rules of successful Western market economies to planned economies is not a sufficient condition for a good economic performance. What is needed is an analysis of the evolution of institutional order over time, whose purpose is to study the conditions in which new institutions fit successfully into an existing structure.

What we would like to highlight now is that solving these three kinds of problems comes down to provide a solution to what we are agreed to call the permanency-flexibility dilemma faced by any transition economies. Our own analysis is inspired by Lachmann's theory of institutions.<sup>12</sup>

Following Lachmann's logic, if not all institutions<sup>13</sup> take on the same status and function,<sup>14</sup> they all share the flexibility property linked to the permanency of the whole: "Institutions rise and fall, they move and change. An institution may last a long time, but during this time assume new functions or discard old ones" (Lachmann 1970:77-78). The permanence of the institutional order does not involve the permanence of each part. The matter is thus to make institutional change and structural permanence compatible, since it is not so much the change *per se* which causes problems here, rather than unexpected changes. Only the last type of change is likely to upset some plans in the course of actions<sup>15</sup>: let us recall that the coherence and permanence of the institutional order by reducing the uncertainty of the future which enshrouds all human action, and by helping to overcome the limitations of their ignorance of the present, are of primary importance in tracing all the major conditions of rational action.

But how is the need for coherence and permanence reconciled with the need for flexibility in the real world? The solutions put forward by Lachmann are, as we shall see, of primary importance in explaining the specificities of the Chinese transition.

The first device available to every society in order to defend itself against such a dilemma is to prohibit change which threatens to upset the social order, and to act against the interests engendering this change. This well-known solution has, however, been used unsuccessfully in the past by numerous planned economies.

The second, less radical, device consists of 'widening' an existing institution in such a way that it can serve new interests without upsetting the plans which led to the institution. Although this solution, contrary to the first, reflects an active behavior which is likely to keep the permanency-flexibility dilemma in check, it can only really be used in transition economies as a complement to a wider institutional policy.

The third device is based on the distinction previously made between designed and undesigned institutions. As we have seen, a harmful outcome from the occurrence of change concerns the relationship between these two kinds of institutions. The problem must be summed-up in the following terms. On the one hand, as institutions can only be designed to face specific, well-known situations, it appears that "the unexpected change of undesigned institutions may not merely jeopardize the coherence of the institutional structure as a whole, but, in addition, may obviate the very design of the designed institutions" (p. 68); on the other hand, designed institutions also change and we have no reason to believe that

their speed of change will be less than that of undesigned institutions. The processes of change of the two classes cannot be regarded as being independent of each other and must consequently be treated together.

The solution proposed by Lachmann in order to cope with this complex relationship consists in setting up designed institutions which allow the integration of change without altering the institutional structure as a whole. The notion of *interstices* within the legal order is then a key component for institutional dynamics. The function of those interstices is actually to lead to the accumulation of sediments coming from the evolution of undesigned institutions so that the coherence of the whole remains intact.<sup>16</sup> The economy then exhibits a few 'fundamental' designed institutions which are not mutable, associated with a fairly wide sphere of 'contractual freedom', a sphere in which frequent change must be expected and which may be regarded as the main source of undesigned institutions. In Lachmann's terminology, the *external* institutions must provide the outer structure of the economy in the interstices of which the sediments of individual efforts in the 'free and mutable' sphere can accumulate (p. 90). Hence, although any society is fundamentally made of two types of institution, the *external* ones, which constitute the outer framework of the society, and the *internal* ones, which gradually evolve as a result of individual plans, the institutional dynamics arise, however, from the specificity of those interstices shared by both kind of institutions.

Given the analytical framework presented above, the aim is now to show how decentralization has played a central role in Chinese reforms.

Decentralization generally occurred when the central government agreed to give some responsibilities to local governments, creating a hierarchical structure of power. Two main reasons are proposed in order to legitimate this policy. The first one, associated with the precursor work of Hayek (1945) considered that, because local governments and consumers have better information than the national government about local conditions and preferences, they will make better decision (Qian and Weingast 1997). The second—associated with the work of Tiebout (1956)—argued that competition among jurisdictions allows citizens to sort themselves and match their preferences with a particular menu of local public goods. Following these arguments, a great number of works highlighted that a decentralized furniture of public goods resulted in a better efficiency than a centralized one. However decentralization also exhibited some limits such as an increase of corruption (Prud'homme 1995). In fact, it appears more and more obvious that the two level of regulation (central and local) articulated themselves in a complementary way (Caillaud et al. 1996).

Considering the size of China, no one program can be discussed without taking into account spatial considerations. To understand the foundations and the evolution of the reforms, one must consequently refer to the organizational dimension of the Chinese economy. In China, there is a long tradition of decentralization, whose evolution reflects the changing orientation of economic and political strategy. The reform program has, then, been applied logically, not only by central government but also by local governments.<sup>17</sup> A wide array of literature dealt with the role of local governments in China. They analyzed the very original experience of this country by underlining for instance how decentralization preserved the market under authoritarianism (Li and Lian 1999) or how local governments have incentives to privatize (Cao et al. 1999). Our work, although complementary with these ones, focused on the institutional dimension of decentralization. Chinese Reforms

began in 1978 with the choice of an incremental approach. One of the main proposals was the development of agricultural and industrial activities out of the Plan. This experience is original because the search for a market economy does not imply the end of the state. Chinese economy is still a mix of public, private and collective economy. The role of the central state remains important, even if it appears to be less dominant than before.

After first underlining the permanent character in the Chinese economy of pre-existing decentralized institutions, we then explain how local governments consequently played the role of “points of orientation” which authorizes the development of some kind of undesigned market institutions. Considering that the objective of the reform is mainly to develop a competitive economy and to assign to the firms a hard-budget constraint, the restructuring of TVEs and SOEs appear to be at the hearth of this process.

## **2. The Decentralization and the Institutional Dynamics of the Reforms in China**

### *2.1. The Decentralized Nature of the Chinese Economy*

In China, there is a very strong spatial hierarchy in administration and local power is really effective. There are six layers of government hierarchy: central, provincial, prefecture, county, township and village. The regional dimension has always been important in China, but regional policies sometimes changed and we may distinguish two periods: Mao’s era and Deng Xiaoping’s era.

The Maoist strategy dominated the Chinese development until 1978. In 1949, the Chinese economy was suffering from extreme regional imbalance: over 70% of the industrial assets and output were concentrated in the coastal areas. Even in these areas, there was a concentration in the big cities. It was a typical under-developed country schedule with few big industrial centers and a large agricultural hinterland. The Maoist policy was influenced by the Soviet theories of regional development. The strong interior-coastal imbalance was regarded as economically irrational and politically dangerous (Yang 1997). It was economically irrational because of the size of the country: some industries were located far from raw material and energy supply areas; the transport system was under-developed and costly; and the resources in inland regions were under-exploited. It was, moreover, politically dangerous because the more industrialized and rich regions were also highly vulnerable to foreign military power. It thus represented a strong risk for national security.

The objective of the government was consequently a balanced regional development and investments in inland regions were encouraged. The *First Five-Year Plan* indicated that new industrial bases were to be built to rectify the irrational spatial distribution of Chinese industry (Yang 1997). During the period 1953–1957, almost two-thirds of the major projects, especially those financed by Soviet aid, were located in the interior. The same policy was pursued during the *Great Leap Forward*, with an emphasis on heavy industry. In 1964, Mao decided to concentrate all the resources on military industries in the interior. This policy is known as the *Third Front Programme*; the country was divided into three fronts corresponding to three regions, coastal, central and western. The defense-oriented industries were located in the third front.

The results were not good from an economic point of view, but it was difficult to stop this program, even after the *Cultural Revolution* (1966–69), notably because of decentralization<sup>18</sup>: the leaders in Beijing could not control how each locality used the funds at their disposal, and it was difficult to stop the projects. It is important to note here that the regional development policy over the whole period reflected the various strategies—economic as well as political—which prevailed at state level: at the beginning, the main objective was to achieve a balanced distribution of industry and of power between regions, whereas after 1964, the projects had few links with local economies and were based on military-strategic considerations. All these investments followed, however, a common redistributive logic.

Two waves of decentralization occurred in 1958 and 1970 which gave great power to local governments with respect to the regional economic development. As the objective of the Maoist era was local self-sufficiency, the main types of industry were duplicated in each region. The result was described as a cellular and encouraged localism. After the *Great Leap Forward*, the crisis led the central government to temporary re-centralization. In 1972, new Sino-American relations appeared, *The Third Front Program* was reduced and imported projects were approved.

It thus seems obvious that regional policy exhibited a rather strategic statute under Mao; local government consequently enhanced its economic power, even if the investments were sometimes counterproductive.

With Deng Xiaoping, decentralization remained important, but took another form, exhibiting a radical reorientation of Mao's policy: the central government encouraged specialization, and the significant growth of rich coastal regions was supposed to stimulate growth in inland regions. The sixth and seventh *Five-Year Plans* emphasized different paths in regional development. The objective was to accelerate the development of the coastal regions. Each region was to develop its comparative advantage. Central government policy became very discriminating with the creation of the well known *Special Economic Zones* or *Open Cities*, at the same allowing time local governments to retain more revenue and to encourage private and collective business.<sup>19</sup>

The new decentralization of the 1980's allowed the development of a new variety of localism with deep implications on Chinese politics (Womack and Zhao 1994). Reforms leading to a market economy accompanied the end of the ideological commitment which instituted the elimination of the main differences between people, regions, etc. On the contrary, everyone was encouraged to pursue his own interest.

However, it is important to note here that the relation between central power and local governments must be seen as an endless cycle of centralization and decentralization. Since 1949, the central-provincial relations have moved towards an emphasis of the power of local government. "In this way, the image of the provinces, and their leaders, has moved from one of the loyal agents of the Center in the totalitarian literature of the 1950s and 1960s, to that of responsive but coerced entities during the Cultural Revolution and, since the 1980s, to an image of the powerful if unequal bargaining partners of the Center. The unfolding of events within China led analysts to recognize that provinces did, in fact, wield power vis-à-vis the Center" (Li 1997:780–781). But this increasing power was not linear, as shown by occasional, but strong, re-centralization measures. Nevertheless, provincial power



accumulated incrementally over time, in a kind of evolutionary process, even if one should not conclude that, over the same time period, central power was overwhelmed, especially because central authorities maintained a strong political power.

In fact, reality shows that, above all, local governments served central government objectives. They provided the stable administrative organization needed for the implementation of reform policy; in this way, they were the main actors of the changing balanced or unbalanced regional policy.

In this perspective, the so-called flexibility of the Chinese experience must be found in the possibility of experimentation with certain economic decisions in certain regions before extending the experience to other ones. This was the case with the responsibility contracts in agriculture which had been authorized and tested in certain regions before being extended to the others, even if such a measure remained forbidden by the central government.

In the same way, there was a provincial discretion which referred “to action and inaction taken by provincial governments without the formal endorsement of the Center, which involves written affirmation by the Center through formal documents. Whilst in the reform period provinces have acquired substantial resources and thus leverage vis-à-vis the Centre, as a result of the cumulative effect of previous decentralization measures” (Li 1997:778–779). The observation of the rich provinces of Guangdong and Shanghai shows five types of provincial discretion (*ibid.*). The first type refers to a bargaining process with the Centre for more favorable policies, through which the provincial government sought to obtain greater autonomy in investment implementation and policies. The second relates to a bargaining process with the Center for more direct central support, for instance from the budget or in the form of bank finance. The third type of discretion concerns the flexible implementation of central policies: that means the possibility for the local governments to engage in various creative interpretations of central policy in order to attain provincial objectives. The fourth type is devoted to the development of the “new horizon” of investment expansion: local governments moved from state budget and the conventional state sector, closely monitored by the Center, towards the burgeoning market. The fifth type refers to the international competence of the province, that is the freedom to define and to apply a strategy to attract additional investment and then to bargain for a greater autonomy from the Center.<sup>20</sup>

Another element of flexibility concerns the fiscal reforms which were implemented by the central government to give more or less power to local governments. For instance, in the fiscal reform of 1982, the reallocation of functions and the power to tax was given at the lower level, the counties and the villages, precluding the possibility for a village to transfer its budget deficit to a higher level. The consequence of these new budgetary relations was fiscal discipline: local governments became subject to a hard budget constraint, being permitted to spend more, only if they could generate more revenue. “These reforms have helped unleash the entrepreneurial spirit of local bureaucrats, fuelling the rapid growth of rural industry” (Park et al. 1996:751).

From a political point of view, it is hardly controversial today to say that, thanks to the decentralization, local bureaucrats sustained the move towards a market system. By referring to the choice between exit, voice and loyalty (Hirschman 1970), one can say that

“not only the costs of exit but also the costs of protest declined due to the decentralization scheme” (Krug 1997:275). The central government wanted to secure its political support of provincial officials by increasing local autonomy. There was a commitment to a greater decentralization of decision-making based on the principle “the more you collect, the more you spend, the less you collect, the less you spent, rely on yourself to balance accounts” (Park et al. 1996).

Finally, if the central-local relations are not clear, it appears that the role of the Center in the Chinese economy was reduced over the reform period: “from a perspective of a market economy, the decline of the part of total investment controlled by central government permits the allocation of scarce resources by decentralized economic agents which may enhance the efficiency of investment” (Yang 1994:72).

The decentralized framework of the Chinese economy has, thus, always been used by central authorities as the main transmission vector of the successive economic reforms. Put in terms of the analysis of institutional change presented above, the task is now to explain how decentralization, conceived as a permanent designed institution handled by the authorities, encouraged the development of a sufficient large range of contractual freedom required for the move toward a market-like economy, that is how decentralization contributed to resolve the permanency-flexibility dilemma faced by the Chinese economy.

#### *The Local Government as a “Point of Orientation” in the Chinese Transition Process*

The analysis of the role of local governments in the transformation of the Chinese economy from a centrally-planned economy to a mixed system with a state intervention and market mechanisms, requires that we return to the notion of a point of orientation introduced previously. The idea is that local governments must be seen as a point of orientation, that is a permanent institution which have sustained the evolution of other institutions and, first of all, of firms in the changing environment of a transitional economy.

As we have explained, decentralization has always been an important part of Chinese policy, but until the beginning of the reforms, the objective was mainly to support central government policy, namely the central plan, with funds distributed by the Center. From the beginning of the reforms, at the end of the 70s, the role of local governments has changed, having more autonomy, even if the hand of the central government is still very much in evidence. In other words it appears that the fixity of local governments goes hand in hand with the flexibility of their attributions.

A central point of the reforms relates to the capacity of the enterprises to adapt to market constraints with efficiency objectives when market institutions do not exist. The issue refers to two related aspects: the enterprise governance and the institutional environment. Generally speaking, enterprise governance has to face the problem of budgetary constraints and the institutional environment refers to a problem of moral hazard and credibility. Focusing now on two of the main reforms, that is first on the adaptation of Township and Village Enterprises (TVEs) to market rules and to competition at the beginning of the reforms, and second on the privatization of State Owned Enterprises (SOEs) from the mid 90s, we will explain how local governments have been the mainspring of the evolution.

*The Development of Local Governance*

Let us recall that a TVE refers to an industrial unit that belongs to all residents of the rural community in which it is located. The rural community may be a village with around 200 households or a township with 3500 households. It is here important to notice that both rural sector and rural population were never included in the central Plan. The investment decisions were consequently taken by local governments independently of the central government. Decentralization occurred only in urban areas for which investments were decided by the central Plan. Another specificity of rural areas is the collective land ownership. The local governments attributed the land to peasants, factories. . . but nobody has property rights on the land. Consequently, the peasants cannot sell the land. These two variables (rural/urban government investment and collective land ownership) represented two of the important path dependent variables which constraint TVEs' development.

But, even if one encounters a rural industrialization in China, many of the TVEs are located in relatively industrialized areas and still more are close to such areas.<sup>21</sup> There is great diversity in the ownership of TVEs; most TVEs' industrial output is, however, produced by firms that are controlled by local township and village governments. Despite the "collective" label, TVEs themselves were never worker co-operatives; they were instead labeled "collective" because they were established and controlled by agricultural collectives. When the latter dissolved in the early 1980s, their functions were either decentralized to individual household or else assumed by local governments (Naughton 1994).

The commitment of local governments to organizing local business originated in the commune system, when community governments were responsible for agricultural production. The inception of the commune system can be traced back to 1958 with the failure of the first experiments.<sup>22</sup> It re-emerged during the agricultural mechanization drive of the early 70s. The rural small-scale industrial enterprises involved, "being simultaneously units of local government and economic organization, in a non-elective system in which authority resided exclusively with the Communist Party" (Putterman 1997:1645), often became sub-contractors of SOEs. The TVEs are the extension of this commune system and they are *de facto* managed by local governments: "As a result, most TVEs became subordinated to the township and village governments (. . .) Village and township leaders are appointed by county administrators. Township and village leaders, in turn, designate the manager of TVEs" (Naughton 1994:267).

In 1990, TVEs were brought under regulation: ownership rights of TVE assets, allocation of control rights and rules concerning distribution of after-tax profits became clearly defined (Che and Qian 1998).

Assets of TVEs are owned collectively and the ownership rights of the enterprise assets didn't change, even when the enterprise was under a managerial contract responsibility system, or when it undertook joint operations with enterprises of other types of ownership. The owner holds the control rights, determines the direction of the business, selects managers and settles the distribution of after-tax profit. The part retained by the enterprise should be no less than 60% of the total and should be used for the increase of the funds for production development in technological transformation and expansion of reproduction. With respect to the part remitted to the owner of the enterprise, it should be used mainly for the support

of construction of agricultural infrastructures, agricultural technology services, rural public welfare, renewal and transformation of enterprises, or development of new enterprises. Thus the uses of the revenue by residents, as well as by the government, must be essentially devoted to reinvestment and local public goods.

The autonomy of TVEs is great, but restricted to daily operation decisions (Che and Qian 1998). The main decisions are taken by local government which selects managers, has the responsibility for strategic decisions, such as investment and finance, and which uses the after-tax profits for public expenditure.

TVEs, then, seem to be perhaps the best image of the decentralized nature of China's economy. The latter has not only always been more decentralized than any other planned economy (Qian and Xu 1993), but reforms have logically focused on further decentralization. Thus, although the commune system was responsible for agricultural development, the reforms established the preponderance of TVEs for implementing industrial development, even if, initially, it was not in the objective of the government to help rural industries. Indeed the reform initiative (*baochan daohu*—contracting production to the household and decentralization from the center) was initially designed to constrain rural industrial development (through denial of credit, finance, energy, export licenses, raw materials, and other capital goods) in order to garner political gains and to improve the position of the politically favored SOEs. The most important unintended consequences of this intended policy change from the center, was however the rise of TVEs; and the rise of rural industry defeated the urban SOEs. One may recognize here a kind of interaction between an intended policy change and the “unexpected change of some undesigned institutions.” Such interaction highlights, if necessary, the role played in China by the local governments. The coordination mechanisms provided by local governments prevented that the “unexpected change of undesigned institutions” (the rise of TVEs) altered “the coherence of the institutional structure as a whole.” In all the cases, local governments kept the main responsibilities and decentralized institutions must really be seen as the fixed points of orientation upon which the evolutionary (intended as well as unintended) process of reform is based.

The question now is to establish how such institutions have facilitated the creation of new market institutions, that is of the development of some kind of market rules and behaviors. The answer is twofold and requires an explanation of how decentralization first induced the adoption of a hard budget constraint rule by the firms, and then provided a solution to the problem of property rights and the moral hazard.

The notion of a soft budget constraint upon which, in any planned economy, the behavior of the enterprise is based, refers to the idea that the government cannot credibly commit to stop an enterprise activity because of the losses in private benefits for workers and managers (Qian and Roland 1996). The analysis of a soft budget constraint generally assumes that the state is the single owner in the economy.<sup>23</sup> However, there are in China a great number of owners, and especially of different jurisdictions. One of the consequences is that we do not observe a bilateral monopoly relation between firms and the state, which leads to a regime of bargaining, and in turn softens budget constraints and weakens financial performance (Walder 1995).

In China, local governments acted as industrial firms because first, their autonomy *vis-à-vis* the central government is strong, and second, the fiscal reform stimulated this kind

of behavior. Before the reforms, each level of government under the Centre received an annual budget from the level above. If there were any surplus, it was appropriated by the level of government immediately above. The reform of the mid-1980s changed these rules.<sup>24</sup>

First, instead of government automatically appropriating all the profits of the enterprises under their jurisdiction, the enterprises were to be taxed according to a fixed rate (Walder 1995); the residual, retained by the enterprises managed by local governments, constituted a strong incentive for the former to be more profitable.

Second, regarding to the tax revenues collected from enterprises under their jurisdiction, the reform authorized each level of government to turn over a contractually specific amount to the level of government immediately above, the potential residual being kept by the lower level. Conversely, local governments became responsible for covering shortfalls. The different regions experimented with different systems and, consequently, a wide variety of contracts. Generally, the contracts included a fixed sum plus some formula for sharing the revenues collected (Walder 1995). Even if villages were officially outside that system, they often had the strongest incentives. Indeed, although villages had to pay a tax to the township government, all the residual went to the village government; “the villages are treated by the township government exactly as a private enterprise under the township would be” (Oi, quoted by Walder 1995:280).

Furthermore, the reforms created the possibility of extra-budgetary funds; this possibility constitutes a strong incentive for sub-national governments to set up a hard budget constraint and to close the non profit firms. The idea is that the budget constraint of enterprises can be hardened through fiscal decentralization which gives local governments an incentive to enter into fiscal competition. It is obvious that in China there is competition in infrastructure investments to attract foreign investment. For example, the campaign initiated by the Center to restrict investment over the period 1989–1991 had only limited effects on the level of investment in Shanghai and Guangdong (Li 1997). The reason is that fiscal competition under factor mobility increases the total marginal local value of infrastructure investment above its marginal social value, and therefore induces more infrastructure investments.

Another argument in favor of the existence of a hard budget constraint in the Chinese regions refers to the sources of the so-called soft budget constraint. There are indeed two main sources of soft budget constraint for a local government: soft fiscal transfers from higher government levels, and access to credits. We have explained that the fiscal reform and the fiscal contracting system have limited the possible amount of fiscal transfers for local governments, thus inducing a hard budget constraint (Wong 1991). These governments have logically been pushed to turn to the financial system for additional funds. However Qian and Roland (1996), showed that, at the highest level, the governments exerted a strong political influence on the lending decisions of bank branches. In contrast, township and village governments’ influence over financial institutions is very limited. One can, then, conclude that decentralization allowed the local governments to achieve commitment to hard budget constraints. Finally, even if decentralization has exhibited some negative effects in the sense that it has led to an excessively tight regional fiscal budget and some wasteful duplicated investment decisions, it may also have helped to harden budget constraints, as

local authorities prefer to allocate budgetary resources to infrastructure investment rather than to bail out enterprises (Qian and Roland 1996).

A final point must be underlined: there is a link between the size of the firm and the nature of the budget constraint. TVEs are generally smaller than public firms and thus easier to close. In other words, their propensity to face a hard budget constraint is higher. Empirical evidence shows that, during the period of the austerity program in 1989–90, about three million TVEs went bankrupt or were taken over by other enterprises. All of this confirms the fact that the local governments, which applied the central plan during the era of Mao, adjusted themselves to the new conditions of the reform era in order to facilitate the adoption of new market mechanisms in the Chinese economy.

If local governments have encouraged the development of a sphere of contractual freedom, it is also because they contributed to secure the environment and property rights.

One of the difficulties encountered in implementing market rules is the lack of credibility. The foundations of a market economy consist essentially of well-defined property rights. In China, property rights are very ambiguous. Most of the non-state firms are collectives and we have seen that the owners of these collective firms are the residents of the community. However, their rights are ambiguous and poorly respected, and the power belongs to local governments. Surprisingly, the collective ownership pattern doesn't have a precise legal definition; "in most cases that have been studied, township and village officials in their official capacity possess all the key components of property rights: control of residual income, the right to dispose to assets, and the right to appoint and dismiss managers and assume direct control if necessary" (Naughton 1994:267). In this context, TVEs present the advantage of facilitating cooperation through implicit contracts among community members connected by ongoing relationships. Long-time communities incite residents to create a form of income sharing that may be an optimal form of organization when the legal system doesn't exist. The best illustration of ambiguous property rights is the joint control of firms by entrepreneurs and local government (Li 1997). By choosing to register the firm as collective, entrepreneurs intentionally invite the local government to share the control rights.<sup>25</sup> In 1992, 60% of production decisions of entrepreneurs were subject to local interference. Local governments step in here to facilitate transactions when market mechanisms fail.

#### *Local Governments and the Privatization of SOE*

The reform of the enterprises characterizes the gradualism character of the Chinese reforms.

The urgent need for a reform of the State Owned Enterprises became evident in the mid-90s. The SOE were owned by the central government, but they were supervised by the central, provincial, city and county governments. The philosophy of the reform is contained in the idea: "grasping the large and letting go the small." The practical consequences of such an idea are as follows: (i) the central government kept the largest enterprises, (ii) the other large enterprises were offered to conglomerations and corporations by means of mergers, (iii) the small SOE were privatized at county level, (iv) a mass lay-off of SOE workers appeared at the city level.<sup>26</sup>

It is important to note here that local governments, after the TVE experience, initiated SOE privatization and consequently played a critical role in the implementation of this

reform. The central government used the provincial governments to make privatization possible. The local governments' incentives are partly similar to those we met with in analysis of TVEs: the access to a harder budget constraint and to competition.<sup>27</sup> It played an active role in the introduction process of market rules and consequently in the increase in lay-offs.

At the beginning of the reforms, 80% of SOE were small. Their performances were relatively low, weighing on the local government budgets. Because the local governments have better information, they could adapt the nature and the path of the reforms. The central government didn't force the local governments to implement these reforms at the same speed, and one may observe a great variety of approaches to reform: by the end of 1996, 70% of SOE were privatized in pioneering regions, half in many other provinces (Cao et al. 1999).

The main problem was that in some traditional industries, SOE were no longer competitive with the entry of non-state firms. For example, Shanghai's textile and measurement instruments industries became non-competitive compared with TVEs; in 1996, the city consequently chose to organize two "re-employment service centers" in these industries. These centers are responsible for subsistence level support for the laid-off workers and for training. They are financed by the city government, the new textile and measurement companies and by social sponsors.

However, if Shanghai, as a big city with a large foreign investment inflow, were in a position to close down certain industries over a short time period, the situation is once again different according to the regions. The experience of Heilongjiang is very instructive from this point of view. Heilongjiang is well known for its heavy industries, of soviet type, which are no longer attractive for foreign funds. Confronted by the problem of restructuring, the region found its own original solution. After an experiment in the coal mining sector, the provincial government adopted the "3-3 scheme": one third of employees would continue in their jobs, one third would engage in new tertiary industries and one third would go to agriculture because of abundant uncultivated land. The program was applied to the main sectors of the region and the results were successful with 16% industrial growth in 1996.

The most important features concerning local government certainly lie in their responsibility in lay-off and re-employment. The combination of both factors can be viewed "as an attempt by local governments to address both the ex-ante and ex-post political issues surrounding reform" (Cao et al. 1999:114). In the absence of well-functioning social welfare institutions, the local governments provide financial help to lay-off workers who then receive a credible compensation. Moreover, when a local government helps a worker to find a new job, it creates a positive political environment in which the worker with a new job is less likely to oppose the reforms.

Thus, when local governments, (i) have primary authority and responsibility for their local economies, (ii) are subject to hard budget constraints, and (iii) are unable to protect their economies from outside competition, experience shows that they contribute decisively to the adoption of market rules and contractual freedom in the Chinese economy. They represent perhaps the main transmission vector of market forces into the planned system.

## Conclusion

The Chinese experience is very instructive for the analysis of the institutional dynamics of any transitional economy. In Eastern Europe, the objective of reduced state intervention has been translated as a need for rapid privatization. The result was that the old system was destroyed before the new one could replace it. So, one may speak of an “institutional hiatus” (Kozul-Wright and Rayment 1997). In China, we may observe an evolution rather than destruction. Such an evolution, which successfully combined the logic of a planned economy with that of a market economy, benefited from the preponderance in the Chinese system of a kind of decentralized institution.

That doesn't mean of course that the shock-therapy model is always inferior to the gradualism one, the latter being the model for any transitional economies.<sup>28</sup> That doesn't mean either that the success of the Chinese Reforms is warranted.<sup>29</sup> That solely means that the institutional component played a critical role for explaining the coherence of the transitional Chinese process. By managing the development of a sphere of contractual freedom, decentralized permanent institutions facilitated the coexistence of two economic logics often considered as being radically opposed. In other words, decentralization appears to be one of these designed institutions which allows the integration of change without altering the institutional structure as a whole. This is the major lesson that other transition and emerging economies may draw from China's experience.

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## Notes

1. For Jin and Hayes, the leading sectors that have successfully created positive feedbacks for economic transformation are the agricultural, service, foreign trade and investment sectors (1997:86–91).
2. See, for example, the numerous contributions to *The Journal of Economic Issues*, especially Adkins (1991), Ostas (1992), Koslowski (1992), Brown (1993), Elliot and Dowlah (1993), Schlack (1993), Liew (1995), Lichtenstein (1996) ...
3. “An institution provides means of orientation to a large number of actors. It enables them to co-ordinate actions by means of orientation to a common signpost” (Lachmann 1970:45).
4. That is, “if the institutional framework rewards piracy then piratical organisations will come into existence; and if the institutional framework rewards productive activities then organisations-firms-will come into existence to engage in productive activities” (North 1994:361).
5. Planning can simply stop its function as the central agency of resource allocation.
6. One may recognize here the case of Russia, even if, in Russia, Mafia-like organisations pre-existed before the reforms. We must mention here that a broad literature explained how *de facto* organizations such as “mafia-type” organizations may also be considered as being a part of a market stage. On this point see Grossman (1988, 1989) and Hewett (1988a, 1988b).
7. That is a situation in which all institutions will easily fit into a coherent whole (Lachmann 1970:69).
8. For example, as we shall explain latter (Section 2), in China the central government kept the largest, inefficient, State Owned Enterprises (SOE) in order to facilitate the privatization of the efficient small SOE. On this point see for example Smyth (2000).



9. "Almost any change takes time and so do its repercussions (...) it takes time for successful modes of action to crystallize into institutions. It takes time even for the participants to find out which action was successful and which was not. It takes further time for such knowledge to become diffused among potential imitators" (Lachmann 1970:89).
10. The creation process of new-original institutions follows logically the same kind of constraints and difficulties.
11. One may recognise here the Mengerian distinction between *pragmatic* and *organic* institutions.
12. For a more detailed report of the theoretical issues of Lachmann's works on institutions, see Dulbecco and Dutraive (2001).
13. This is in the broad sense of the term, that is comprising both designed and undesigned institutions.
14. Some are more fundamental than others in the sense that they are basic institutions of the society, "they must exist before there can be markets which function smoothly" (Lachmann 1994:50).
15. The issue is, of course, all the more important because the institutional change affects long-term plans.
16. In this perspective we shall see later (Section 2) how Township and Village Enterprises (TVEs) development represented in China a key element for the expansion, inside the old system, of some kinds of contractual relationships.
17. It is usually considered that the Chinese reform was bottom-up contrary to the Soviet one which may have followed a more top down approach (Berliner 1992). Our point of view is however that the Chinese experience appears to be more complex and original. Indeed even if initially the reforms were clearly decided by the central government, all the provinces were not concerned at the same degree. Generally a new reform was authorized and applied in only one or two provinces. If successful, the others provinces implemented this reform even without the authorization of the central government.
18. It is well known, however, that economic efficiency was not Mao's main concern.
19. One consequence of the implementation of *Special Economic Zones* in Guangdong and Fujian was an increase of the migration of firms coming from others provinces in order to have the advantage from trade liberalization (Wei 1999).
20. According to Li, Li and Zhang the lower is the level of jurisdiction, the greater is the provincial discretion. In this perspective county-level seems to be the more economically successful jurisdiction level (2000:285).
21. Sometimes little, or no, farm land remained in rural areas so that the distinction between urban and rural areas is not so clear (Putterman 1997).
22. See Che and Qian (1998), for an historical analysis.
23. On this point see, for example, Kornai's work (1990).
24. It is important to notice that the reform partly confirmed *de jure* a situation which previously existed *de facto*.
25. In 1978 the gross industrial value was 94 800 million yuan for TVEs and 328 900 million yuan for SOEs; in 1999 the values were respectively 4460 700 million yuan and 3557 100 million Yuan (China Statistical Yearbook 2000:409).
26. For more on the role of the banks with the SOEs, see Lardy (1999).
27. The reduction of transaction costs constitutes another incentive.
28. Poland's success since shock therapy indicates that that model may be the best one.
29. See on this point the works of Shirk (1993, 1994) and Zhou (1995).

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