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Susan H. Whiting
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Explaining Institutional Change

AMID predictions that the opening years of the new millennium will usher in a "Chinese century," we are confronted daily with conflicting images of the Chinese state – at once predatory and developmental, weak and strong. Indeed, the "reach of the state"[1] is an issue of vigorous debate not only among students of Chinese politics but also among students of comparative politics. The debate centers on the capacity of the state to promote the generation of wealth and to command some portion of that wealth for state purposes.[2] While arguments about state strength or weakness pervade the literature, they are, by their very nature, inconclusive. What the debate fails to capture fully is the extent to which state capacity changes over time and varies across policy arenas and geographic settings. Rather, the "reach of the state" ultimately depends on the nature of the institutions that govern the economy and society. This study moves beyond formulations of state strength or weakness and focuses the analysis on issues of institutional variation and change.

Institutional change is at the heart of the rapid socioeconomic transformation in China since 1978. With one of the fastest growing economies in the world at the beginning of the twenty-first century, China is simultaneously making the transition from agriculture to industry and from

[1] This term is borrowed from the title of Vivienne Shue's (1988) book, *The Reach of the State: Sketches of the Chinese Body Politic*.

[2] A note on my use of the term "state" is necessary at the outset. While a convenient shorthand, the term is in no way intended to imply that "the state" can act in any meaningful way apart from the individuals who populate its offices. I adopt the Weberian definition of the state as a complex organization, staffed by individuals and composed of numerous agencies across various levels of administration, that has a monopoly on the legitimate use of coercion and the authority to establish binding rules in a given territory (Gerth and Mills 1946:78).

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socialism to capitalism.[3] This study examines changes in the institutions governing one of the most dynamic sectors of China's economy – the rural industrial sector.[4] Rural industrial output has grown at an average annual rate of nearly 25 percent in real terms since the initiation of economic reform in 1978. As of the late 1990s, it accounted for fully 45 percent of total industrial output, although it generated a much smaller share of total state tax revenue (*Zhongguo tongji nianjian* 1998).

While the remarkable expansion of rural industry is undisputed, theoretical puzzles about how rural industrial wealth is generated and who commands that wealth remain unresolved. The first puzzle concerns the striking regional variation in property rights that has characterized China's rural industrial sector.[5] This study focuses on rural industrial development in three locales: Wuxi, Shanghai, and Wenzhou – home to some of the wealthiest and most industrialized counties and townships in China.[6] However, the wealth of these locales was based on very different forms of property rights. Through the mid-1990s, publicly owned firms dominated rural industry to varying degrees in Wuxi and Shanghai, while privately owned firms dominated in Wenzhou. Such variation is surprising in light of the claims of neoliberal economic theory about the strict necessity of private property rights for economic growth. Such variation might also seem surprising because it arose out of the Maoist era, which some scholars (e.g., Kelliher 1992) have portrayed as characterized by uniformity in the rural economic structure.[7] In fact, as this study shows, regional variation stems in part from patterns of state intervention in the economy that prevailed during the Maoist period.

I argue that central state institutions in place at the beginning of the

3 The agricultural sector accounted for half of total employment in 1997. Private ownership of productive assets and market allocation of factors and products occupy growing proportions of the Chinese economy. These transformations play central roles in this study.

4 "Rural industry" refers to all industrial enterprises at the levels of the township (formerly the commune), village (formerly the brigade), and below – hence the common usage of township and village enterprises (TVEs) to refer to the sector as a whole.

5 The rural industrial sector encompasses a wide array of ownership forms ranging from collective firms (*jiti qiye*) that are owned and run by community governments to private firms (*siying qiye*) that are owned and run by individuals. The terms "ownership" and "property rights" are used interchangeably; a formal definition of property rights is introduced in the next section.

6 These locales are introduced in greater detail later in this chapter.

7 By contrast, other scholars (e.g., Perry 1980) have highlighted the ecological and institutional diversity of the Chinese countryside. This study builds on this tradition of scholarship.

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reform era created strong positive incentives for local state officials to promote rural industry. However, the choices of local officials concerning what forms of property rights to support were constrained by distinct local resource endowments inherited from the Maoist period as well as by incompleteness in national market and legal institutions in the post-Mao era. Dependence on local resource endowments on the one hand, and complementarities between the nature of market and legal institutions and the form of property rights on the other, combined to create apparent path dependence in the trajectories of rural industrial development in each region.[8]

As the incentives and constraints created by the national institutional environment changed, however, so did the property rights forms that local officials were likely to support. This framework explains both the apparent path dependence of property rights forms during the first decade and a half of reform and the dramatic move toward privatization of publicly owned firms and widespread support for new entry of private firms that began to occur during the mid-1990s in areas where public ownership had previously dominated. The core of this study focuses on the apparently path-dependent development of distinct regional patterns of property rights through the mid-1990s. The concluding chapter of this book shows how and why movement off the path is now taking place.

The second puzzle concerns the ability of the Chinese state to extract revenue from and control the allocation of credit to the rural industrial sector in ways consistent with central state priorities. This ability is subject to dispute and differing interpretation. Some scholars (e.g., Pei 1997; Walder 1995) find pervasive bureaucratic decay undermining state capacity, while others (e.g., Blecher and Shue 1996; Shue 1988) find growing bureaucratic competence and strength. However, assessments of China as either a weak or a strong state fail to adequately capture the nature of institutional change.

As this study will show, the form and effectiveness of extractive institutions and allocative practices were integrally related to the forms of property rights in each locale. The constellation of property rights determined to a large extent the level of information costs and the distribution

[8] Complementarities arise when the presence of one institution or policy increases the utility of or benefits from another institution or policy. Path dependence occurs when the outcome of a dynamic process is highly sensitive to a seemingly insignificant feature of initial conditions. Its importance in economic analysis derives from the claim that it can lead to inefficient outcomes not predicted by standard neoclassical economic models (Arthur 1989; Liebowitz and Margolis 1995).

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of bargaining power confronting local officials within each community. In communities where private ownership dominated, political and economic power were quite distinct. As a result, local officials faced high information costs in governing private firms. At the same time, the bargaining power of private capital constrained the ways in which local state officials innovated in the design of extractive institutions to cope with high information costs. Surprisingly, however, where institutional innovations were employed to extract revenue from private firms for local coffers, these innovations also revealed new fiscal capacity to the central state.

By contrast, in communities where public ownership dominated, the fusion of political and economic power in the hands of local state officials allowed these local leaders to harness the resources of the community to their own political purposes. Although one might expect the central state to exercise relatively effective control over all public enterprises, even those located at the local level, local officials were able to manipulate revenue extraction to hide fiscal capacity from higher levels and to channel credit on concessional terms from the state-run banking system to local public firms. Ultimately, such strategic maneuvering on the part of local state officials helped to precipitate the initiation of major national reforms in fiscal, banking, and legal institutions beginning in November 1993.[9] As the concluding chapter of this book shows, these reforms have begun to transform the institutional landscape of the Chinese countryside, fundamentally altering the incentives that shape how local officials intervene in the local economy.

This book represents an effort to develop a dynamic approach to the study of institutional variation and change. The approach explores the complex interactions of individuals, institutions, and their broader environment to explain the process of change. In so doing, the book integrates theories located at three distinct levels of analysis. At the individual level, it develops empirically grounded assumptions about the goals pursued by the individuals embedded in local state and market institutions. At the institutional level, it provides an analysis of the incentives and constraints created by local institutions and how those incentives and constraints influence the ways in which individuals pursue their goals. At the level of the national political-economic system, it derives insights from evolutionary theories of economic change to analyze how shifts in the national institutional environment transform the incentives

[9] Zhonggong zhongyang, "Guanyu jianli shehui zhuyi shichang jingji tizhi ruogan wenti de jueding (Decision regarding Several Questions on the Establishment of a Socialist Market Economic System)," *Guowuyuan gongbao* No. 28 (1993), pp. 1286–302.

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and constraints created by local institutions. Viewed from an evolutionary perspective, even dramatic changes have clear origins that can be identified in the interactions of individuals, institutions, and the broader environment in which those institutions exist. This framework helps to explain the dominance of public ownership in Wuxi and Shanghai from the Maoist period through the first decade and a half of reform, as well as the dramatic move toward privatization of public enterprises in these locales beginning in the mid-1990s. It also helps to explain the expanding presence of private capital in the Chinese economy more generally and the challenges for state revenue mobilization that accompany the transition to a private, market economy.

This chapter explicates the theoretical and methodological underpinnings of the study. The opening section examines how social scientists exploring the role of the state in development have come to focus on the evolution of institutions linking the state and the economy. It also presents an overview of the core concepts derived from institutional economics that inform the approach to institutions taken in this study. The next section illustrates how these concepts can be used to explain the evolution of property rights, extractive institutions, and allocative practices in rural industry. The penultimate section describes the research design. The last section provides an outline of the book as a whole.

INSTITUTIONAL CHANGE IN STATE AND MARKET

"The state" has been at the center of scholarly inquiry in the fields of comparative politics and political economy for more than two decades.[10] Reacting against the claims of modernization and dependency theorists on the one hand,[11] and neoliberal theorists on the other,[12] statist theo-

[10] The publication of the volume *Bringing the State Back In* self-consciously marked the reemergence of statism as an important perspective (Evans, Rueschemeyer, and Skocpol 1985). It hearkened back to the classic insights of Weber as well as more recent work by economic historians such as Polanyi and Gerschenkron. Path-breaking works consistent with the statist perspective include Evans (1979), Katzenstein (1978), Krasner (1978), Stepan (1978), Trimberger (1978), and Zysman (1977).

[11] Modernization theory suggests that the nature of the development process is determined mainly by the characteristics and values of the domestic economy and society. Dependency theory explains developmental outcomes based primarily on a country's position in the global political-economic structure and on the interaction between that global structure and the domestic class structure. These theories have been extensively reviewed elsewhere. See, for example, Huntington (1971), Migdal (1983), Smith (1979; 1985), and Valenzuela and Valenzuela (1978).

[12] Neoliberal theory is addressed in subsequent paragraphs.

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rists hold that the state has an important, independent impact on social, political, and economic development within its borders. A central preoccupation of those working in the statist tradition has been to understand the determinants of state capacity – broadly defined as the state's ability "to penetrate society, regulate social relationships, extract resources, and appropriate or use resources in determined ways" (Migdal 1988:4). However, this quest has been hindered by the lack of theoretical tools necessary to build a dynamic theory that can adequately account for institutional change. Such an account is crucial because institutions are themselves the building blocks of state capacity.

The approach to institutional change that I develop in this study weds insights from institutional economics to the concerns of comparative politics. Explaining institutional change requires bridging three distinct levels of analysis encompassing theories regarding the motivations of individuals, the nature of institutions in which individuals are embedded, and the dynamics of the broader environment in which institutions function. As I demonstrate here, much of the recent research in the statist tradition has focused on the institutional level of analysis to the neglect of cross-level theorizing.[13]

Statism and Its Critics

In contrast to statist theory, neoliberal theory regards the interventionist state as a serious impediment to development (Buchanan, Tollison, and Tullock 1980). This view reflects the dual conviction that efficient allocation of resources is the key to development and that efficient resource allocation is best achieved through the unfettered functioning of the market.[14] Neoliberals, therefore, concede only a minimal role for the state – a role limited to protecting individual rights to both person and property and enforcing voluntarily negotiated private contracts (Buchanan 1980:9).

Statist theorists, on the other hand, regard the accumulation of capital for productive investment and the direction of investment capital to particular uses, rather than efficient resource allocation per se, as the keys

[13] Cortell and Peterson (1999) and Remmer (1997) also make this point.

[14] However, the very notion of a free market that functions in the absence of effective regulation by the state has been questioned by political economists and economic historians as diverse as Adam Smith (1965 [1776]) and Karl Polanyi (1957 [1944]). The point has been driven home forcefully by Russia's painful experience with the transition to capitalism. See also Chaudhry (1993).

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to economic development (Amsden 1989; Gerschenkron 1962). Moreover, as Alexander Gerschenkron's fundamental insight reveals, the later the timing of industrialization, the greater the role of the state in facilitating this process. Thus, analysis of the state as an agent of economic development is a central concern of the statist perspective.

Much of the early "state-centered" research equates state autonomy with state strength (Evans, Rueschemeyer, and Skocpol 1985). State autonomy implies that decision makers are capable of pursuing economic goals distinct from those of any particular group in society. The sources of autonomous state interests have a diverse genealogy: they reflect both the realist emphasis on the state's unique position at the boundary between domestic society and the international state system, and the neo-Marxist emphasis on the state's position as ultimate guarantor of hegemony by the putative ruling class (Skocpol 1979; Stepan 1978).

Work in a more empirical vein identifies as sources of state autonomy the degree of insulation of state institutions and political elites from societal pressures and the degree of ideological coherence among those who staff state institutions (Evans 1995; Haggard 1990).[15] In particular, studies of East Asian developmental states have focused on the ability of highly autonomous state agencies to use tax, credit, and trade policies to promote the rapid development of particular industries (Wade 1990).[16] Such ability has enabled the newly industrialized countries of East Asia to demonstrate considerable "virtuosity in moving through the product cycle" in the decades since the end of Japanese colonialism in the region (Cumings 1981:2). In contrast, studies of post-colonial Africa have emphasized the predatory nature of the state, in which state power is used to benefit a narrow segment of the elite, thus undermining rather than enhancing the potential for economic development (Bates 1981).

Elaboration of a typology of "developmental" and "predatory" states, however, fails to capture the complexities of institutional stasis and change. In Peter Evans' (1995) formulation, developmental states such as Korea and predatory states such as Zaire both enjoy significant autonomy vis-à-vis society, but they differ in terms of their societal

[15] This type of research also represents an effort to disaggregate excessively reified notions of "the state" by examining the interests and capabilities of particular agencies.

[16] The best of these studies identify the social, political, and historical roots of autonomy exercised by state agencies. In addition to Wade (1990), see Winckler and Greenhalgh (1988).

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embeddedness. For Evans, embeddedness, or the density of connections between public agencies and private citizens, is essential to the developmental state's ability to formulate collective goals and promote social welfare. "Embedded autonomy" is desirable because embeddedness provides information channels that link state and society and facilitate policy implementation while autonomy prevents state power from being captured by narrow societal interests. This account of embedded autonomy is too static, however. Because Evans (1995:44) defines regime types in terms of the developmental outcomes they produce, his analysis becomes tautological, foreclosing the possibility of analyzing dynamic interaction between state and societal forces. Thus, his analysis fails to explain how state capabilities are enhanced or dissipated over time.

Indeed, examined temporally, the notion of state autonomy and the relationship of state autonomy to state capacity are highly problematic. State governance of capital and the market is continuously subordinated to the political imperatives of maintaining power (Boone 1992; Geddes 1994; Moore 1997:339).[17] The political contingency of state autonomy is apparent, even in paradigmatic cases of the developmental state, such as Korea. The military-authoritarian Korean state was successful in creating a new industrial base through the state's control over a credit-based system of industrial finance (Woo 1991). "State control over finance not only made the implementation of industrial policy possible but had the added benefit of bolstering the power base of the state by creating a whole entrepreneurial class as beneficiaries of the political leadership" (Woo-Cumings 1998:9). Ultimately, however, the autonomy of the Korean state was attenuated by its dependence on the very firms – the *chaebol* – that it had helped to build. Subsequent attempts by the state to regulate the *chaebol* have been blunted and deflected because the financial structure links the fate of the state itself to the fate of big capital.[18] Indeed, the very nature of the business–state relationship in

[17] Writing about Senegal, Boone makes the argument that because of the class origins of the state, the political imperatives of rule in fact led the state to undermine rather than promote the accumulation of capital for industrialization.

[18] See Woo (1991) for a discussion of early attempts at financial reform. This is not to suggest that structural reform is impossible but rather to suggest that it is difficult, requiring the realignment of major interests behind change. The combination of the shock caused by the Asian financial crisis, resultant pressures from the international community, and the election of a new president by fledgling democratic institutions may bring about such a realignment.

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Korea made it vulnerable to threats such as that posed by the Asian financial crisis of 1997. Thus, to the extent that particular interests can colonize the state apparatus, they can undermine both its autonomy and its ability and willingness to implement state policy. As Atul Kohli (1990) points out with respect to India, this phenomenon is particularly common in late modernizers in which the state is a primary agent of development.[19] In these cases, the state controls a substantial share of society's resources; as a result, competition and conflict over access to these resources become focused on the state itself.

The nature and origins of capital have a particularly important impact on the design and effectiveness of state extractive institutions (Tilly 1990). Kiren Aziz Chaudhry (1989; 1997) cites the case of Saudi Arabia to demonstrate that the fiscal autonomy provided by oil revenue actually hindered the ability of the Saudi state to regulate the economy. The state's fiscal autonomy allowed its extractive and information-gathering institutions to atrophy, and, as a result, state policy came to be "informed by primordial ties and political considerations rather than by economic rationality" (Chaudhry 1989:114). In contrast, Chaudhry demonstrates that, although the Yemeni state was dependent for fiscal revenue on the financially independent private sector – financed primarily through labor remittances – the state's capacity to regulate the economy was much greater than in its Saudi neighbor. Indeed, where business interests had developed without state support, they lacked mediating ties with the local state and were therefore less able to block unfavorable policy implementation at the local level. Thus, there is no simple formula equating state autonomy and state strength. The ways in which business interests emerge dramatically shape the subsequent development of the state institutions tasked with regulating them.

Furthermore, Chaudhry (1997), drawing on a venerable tradition of dependency and international political economy theorizing, reminds us that state institutions do not exist in isolation: they function in a broader – in this case, international – environment.[20] For example, the collapse of oil prices on the world market in the 1980s changed the incentives for how the Saudi state would intervene in the domestic economy. Yet, the Saudi state's actions were hindered by the atrophy that had beset its

[19] See also Rueschemeyer and Evans (1985:60).
[20] Chaudhry (1997:18) characterizes contemporary development studies as suffering from "an under-theorized sense of structural junctures in the international economy." See also Stallings (1995).

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domestic institutions. The more general point in this instance is that any theoretical approach must be able to account for two distinct sources of change in the institutions that govern society and economy: the dynamic pressures that come from state–society interactions and those that come from the broader environment in which state–society interactions occur.

Sympathetic critiques of statist theory from the emerging perspective of state–society relations suggest that any assessment of state capacity must examine not only the nature of the state itself but also the nature of society (Migdal, Kohli, and Shue 1994).[21] These critiques stem in part from the tendency of research in the statist tradition to focus on policy making at the central level rather than policy implementation at the grass roots. As Joel Migdal (1988:xvii) indicates, "There is a need constantly to look back and forth between the top reaches of the state and local society. One must see how the organization of society, even in remote areas, may dictate the character and capabilities of politics at the center, as well as how the state (often in unintended ways) changes society." Migdal employs the notion of a "triangle of accommodation" to describe the "disjuncture" between state policy as articulated at the center and what is actually implemented at the grass roots. The "triangle of accommodation" refers to collusion between the local state apparatus and powerful local interests in opposition to "the declared intentions of state leaders and the formal language of laws and regulations" (Ibid:265). This point is crucial in focusing attention on tensions within the state itself. Societal interests are not the only – or even necessarily the most critical – obstacles to effective policy implementation at the grass roots.

In sum, there are potential pressures for institutional change emanating from the dynamics of state–society interactions and the tensions within the state apparatus, as well as from the broader environment in which state–society interactions occur. Institutional economic approaches offer key insights into these sources of institutional change. Before turning to the contributions of new institutional approaches, however, it is necessary to draw out the connections between the comparative political theory discussed thus far and analyses of the Chinese case.

[21] The distinction here is, in part, one of emphasis. As Skocpol (1985:20) points out, even early studies of state capacity demonstrate that states must be viewed "in relation to socioeconomic and sociocultural contexts."

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