

*China's Market Visions*

Chapter 1

“Painted Horses”: Reform Culture and the Phenomenon of Partial Reform

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## I. “Painted Horses”

Noted Beijing University economist Zhang Weiying uses a particularly trenchant allegory to describe China’s reform process. The story involves a village in which the primary work animals are horses, creatures that – at least as the story goes – complain unrelentingly and continually demand food, but provide precious little labor in return. In this allegorical world, zebras are just the opposite sort of animals – efficient, tireless, loyal, and unflappable. After years of extolling the virtues of horses, the village chiefs finally concluded that it would be better for everybody if the community’s horses could somehow be replaced by zebras. Yet, such a switch constituted no small challenge. For decades, the village heads had harangued citizens with, and indeed staked the legitimacy of their rule upon, the idea that horses are wonderful and that zebras are evil, that horses mark the road to salvation, and zebras the path to perdition. Whether through indoctrination, fear, or just force of habit, the villagers had come to accept that horses were right and zebras wrong.

Faced with such a delicate situation, the village heads came up with a solution. Under the cover of darkness each night, they began painting black stripes on a few of the village horses. Each morning at daybreak, the villagers – aghast at seeing zebras in their midst – were repeatedly assured that these animals were nothing more than the same old horses of yore, albeit with a few harmless stripes painted on. Night after night, a few more horses would be painted, and ultimately, people grew accustomed to life among these oddly decorated animals. Everybody could rest assured that for all the painting going on, these were just the same familiar horses, and certainly not zebras.

After another long interval, the leaders, again under the cover of night, slowly began replacing the painted horses with real zebras, wonderful animals that quickly proved their worth in the fields. Village life clearly improved as a result, but all the while, the leadership maintained that these zebras were just horses, albeit with artfully applied stripes. Just as they had with the painted horses, people adjusted to life with real zebras, and though they dared not utter it, they started to conclude that these animals might indeed be real zebras, and that zebras were not so bad after all. Only many years down the road, well after all the horses had been replaced, and well after many seasons of prosperity had passed, did the leaders gather the citizenry and proclaim officially that this was a village of zebras, that zebras were good, and that horses were bad.

As a metaphor, the story resonates, for it captures important attributes of China's economic reforms: gradualism (McMillan and Naughton 1992; Naughton 1995; Rawski 1999), reform on the increment (Ash 1988; Fan and Nolan 1994; Wu 1998), "growing out of the plan" (Naughton 1995), and pragmatism (Pye 1988). Similarly, it illustrates a particular style of policymaking, a style that avoids direct challenges to existing institutions, and instead concentrates on experimentation at the margins of the system. If successful in material terms, experiments are extended bit by bit until they ultimately become de facto national practice. Only then, well after their actual – albeit informal -- implementation, do the practices get sanctified, legitimized, and formalized as official policy (Gregory, Tenev et al. 2000). Extraordinary systemic transformation proceeds without anybody formally declaring the old system dead, and that which was once anathema – whether decollectivization, market-determined prices, private enterprise, or property ownership – ultimately ends up taken for granted as commonplace acceptable

practice. Lastly, the metaphor captures a certain political reality of reform, the fact that at least some societal interests could be threatened by change, and might indeed resist it. Reform, therefore, must include a political strategy, one that eases the populace through change, produces material benefits that garner societal support, and avoids the sort of costs that could galvanize anti-reform coalitions (Hirschman 1963; Lau, Qian et al. 2000; Shleifer and Treisman 2000).

Yet, the allegory indirectly hints at something else rather fundamental, an institutional form that will be the subject of the following chapters. Systems undergoing purposive transformation almost inevitably exhibit a plethora of “half-way” institutions, “painted horses” that do not quite fit standard models, categories, and taxonomies. It is precisely those “painted horses” that this study seeks to understand. Where do such institutions come from, how do they develop, and why do they persist? How can we explain both their evolution – an issue of dynamic change – and their tendency with each passing wave of reform to display certain static attributes over time? How should we make sense of systems like China that on the one hand have undergone radical institutional transformation, yet on the other – particularly in the financial and industrial sectors – exhibit persistent patterns of value destruction? What does it really mean to suggest that a system institutionally is stuck between plan and market?

It is widely recognized that sustained growth in China and other developing systems hinges on the ability to transcend “painted horses” and complete the path of institutional evolution. This study aims to show why that has proven so hard to achieve. At the same time, by focusing on ostensibly “irregular” institutions in a particular subset of economic systems, this study has a broader theoretical aim, to critically assess the

assumptions and analytical approaches scholars frequently employ to understand institutional evolution and structure across all political economic systems.

## II. China's "Unfinished" Systemic Transition

Twenty-five years into a self-described process of "system" reform (*tizhi gaige*) and transition (*guo du shiqi*), China's political economy is still replete with "painted horses." This is as true of the more abstract rules and norms surrounding economic behavior as it is for the more concrete organizations embodying those norms. Over the past two decades, there has been extraordinary, even mind-boggling, institutional change. Planned resource allocation -- particularly in the real economy -- is a thing of the past, prices have been liberalized, an industrial revolution in the countryside has been unleashed, a massive demographic shift toward urbanization is well under way, and for the country as a whole, substantial integration into the global economy has been achieved.

At the same time, we still witness a seemingly contradictory mix of market and non-market institutions, a mix that has existed throughout much of the reform era, and one that appears to be deepening as the economy becomes increasingly industrialized and complex. There now exists a vibrant stock market, the eighth largest in the world in terms of market capitalization (if the two exchanges, in Shanghai and Shenzhen, respectively, are taken as a single whole), but one in which only a third of the market's shares are permitted to trade. The rest remain controlled by organs of the state (Green

2003)<sup>1</sup>. Listed on this market are high-profile public corporations – many of which were in the past traditional socialist state-owned enterprises (SOEs) – whose shares trade internationally, whose business activities extend well into the global economy, but whose ownership remains thoroughly state dominated. Across the economy now exist myriad private firms run by prototypical capitalist entrepreneurs, but more often than not, these firms grew out of locally-owned collectives, the entrepreneurs enjoyed prior careers in the state apparatus, and the firms today remain tightly networked with various governmental agencies and personages (Oi 1999; Unger and Chan 1999; Wank 1999; Gregory, Tenev et al. 2000). The lines between public and private remain blurred at best. On the financial front, there now exist large-scale banks engaged in a bewildering array of commercial operations both domestically and internationally, yet they remain formally state-owned, they invest extensively in state firms, and – like many Chinese industrial firms – remain tightly enmeshed in the state and Communist Party apparatus.

Moving from the level of economic producers to the government itself, we again witness substantial change amidst persistent, difficult-to-classify institutional patterns. On the one hand, since the inception of reform, and with even greater alacrity since the 1990s, governmental policy makers have freed-up prices, induced greater competition through the entry of new firms, reduced regulatory barriers across a number of sectors – including sensitive areas like energy and telecommunications – and, by their own description, fostered the spread and maturation of markets. In so doing, they appear to pursue what Steven Vogel, writing in reference to Thatcherism in the United Kingdom, terms “pro-competitive” deregulation (Vogel 1996). They employ the power of the state

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<sup>1</sup> Though the shares, in rather dubious fashion, are valued at the market prices commanded by the one-third of total shares that do trade.

to fix into place increasingly competitive markets. On the other hand, the Chinese government -- whether in terms of its extensive control of the nation's financial markets, its continued efforts to build "national champion" industrial conglomerates, or its maintenance of a political "pecking order" of firms and an accordingly tilted regulatory playing field (Huang 2003) -- still to this day appears to be aggressively seeking a form of managed capitalism, something akin to what Vogel, writing in reference to Japan, terms "strategic reregulation" (Vogel 1996). The powers of the state are used to distort, supercede, or otherwise manipulate market forces.

This intermingling of attributes usually associated with dramatically different national systems extends across a number of fronts. In industrial policy, the Chinese government today simultaneously pursues a "comparative advantage strategy of development" -- one embodied by the WTO accession agreement and premised on the notion that freer markets bring growth -- and a "pillar industry," "national champion" strategy, one that in most other nations historically has been associated with the idea that fully liberalized markets impede growth (Gerschenkron 1962; Amsden 2001). On the financial front, the government since the late 1990s, again in what smacks of pro-competitive deregulation, has moved assiduously to tackle the most complex institutional challenge of reform, the commercialization of the banking sector and the unwinding of its deep, historically-rooted problems of insolvency. At the same time, in the particular strategies the government employs -- particularly in debt resolution, distressed asset recovery, and recapitalization -- the order of the day is still heavy-handed dirigisme, interventions that hardly resemble what most people associate with government retreat or promotion of markets.

As pro-competitive deregulation and strong-arm state capitalism intermingle, it is not only the strategy and nature of state intervention, but also the very scope of the state itself that becomes puzzling. In some aspects, in a manner unimaginable just two decades ago, the reach of the state has declined considerably, at times benevolently and at others horrifyingly. Public goods provision virtually across the spectrum has been in *de facto* terms privatized, with everything from education, preventive medicine, acute healthcare, legal access, social security, and intellectual property rights protection – just to name a few – available now for the most part only on a fee-for-service basis (Gill, Chang et al. 2002; Lu 2002; Peerenboom 2002; Saich 2002; Saich and Kaufman Forthcoming). On the economic front, direct state ownership of economic producers, in an absolute sense, is down considerably (Tenev, Zhang et al. 2002), as are governmental efforts to directly influence prices in the real economy. The free market appears to prevail in all manner of activity, often shockingly.

In other respects, though, the scope of government remains vast, and by some measures expanding. Governmental connections and networks thread in and out of the commercial sector. Governmental regulatory efforts throughout the economy have been ramped up substantially, as have efforts to build and expand a legal apparatus. On the investment front, at the end of 2002, 74 percent of all domestic intermediated capital still moved through the state-owned banking system, with much of the remainder accounted for by government bond issues (Green 2003). As noted earlier, the government pursues a “comparative advantage” (*bijiao youshi*) strategy of development (Chen 2002) at the same time it pursues traditional industrial policy, industrial policy that in part drives the persistently *dirigist* aspects of the financial sector.

Such difficult-to-classify patterns lead to equally perplexing economic outcomes. Analytically, there is something for optimists and pessimists alike. China overall has achieved a phenomenal twenty-year record of sustained macroeconomic growth, one of the greatest stories of wealth creation in modern history (Stiglitz 1999; Stiglitz 1999). At the same time, with non-performing loans amounting to anywhere from 20 to 40 percent of GDP, or even higher, the nation's banking system today is deeply insolvent (Lardy 1998). Financial intermediation in China today remains bank-dominated, banks remain state owned, and the flow of distressed assets is arguably getting worse rather than better (Ma and Fung 2002). In terms of industrial structure, the private sector has burgeoned and, given recent governmental efforts to shut down small and medium SOEs, now constitutes the single largest ownership category in domestic industry. Yet, most large enterprises – particularly in higher tech, more advanced sectors -- remain state owned. Meanwhile, though China now ranks as the world's fourth largest industrial producer, few if any of its firms – whether state owned or private – have emerged as global leaders. Instead, they compete primarily in low end, low value, non-proprietary activities, ones in which the only effective survival strategy involves intense cost-cutting and cutthroat competition (Steinfeld forthcoming). Finally, and not unrelatedly, per capita income has steadily risen, but so too has unemployment and inequality (Hu 1999). Hundreds of thousands of people are climbing out of relatively primitive agricultural employment, finding jobs in urban industry, and accumulating wealth in the process. At the same time, a vast supply of such individuals ensures intense downward wage pressures. This combination of urbanization and downward wage pressure – one reminiscent of earlier, ugly, and oft forgotten eras in the history of advanced industrial nations – potentially

induces great social tension and systemic stress (Nolan forthcoming).<sup>2</sup> The demand for public goods rises at the very point at which the state and society more broadly proves increasingly unable to provide them.

Social challenges, whether real or potential, are reminders of a final set of institutional ambiguities, those surrounding the internal integrity and coherence of the state itself. In some respects, the Chinese state appears solidly monolithic, internally disciplined, and obviously authoritarian. The Communist Party not only dominates and pervades the governmental apparatus at all levels, primarily through its control over personnel appointments (Huang 1996), but also constitutes the “establishment” in much of civil society, claiming members among the vast majority of the nation’s leading intellectuals, businesspeople, attorneys, doctors, and journalists. Moreover, the government across its vast jurisdictional hierarchy has proven deft at beating back challengers to its authority, whether real or imagined. Organizations like the Falun Gong have been aggressively suppressed, efforts at democratization beyond the village level have unfailingly been shut down (Saich forthcoming), and anything hinting of independently organized labor has been consistently squashed (Cai 2002). In other respects, however, the governmental bureaucracy appears extraordinarily disjointed and often internally at loggerheads, not the stereotypical image of an authoritarian, single party developmental state. The center struggles to maintain fiscal capacity in the face of local extra-budgetary levies, fees, and *ad hoc* taxes (Wong 1991; Oi 1992; Wang and Hu 2001). Local officials routinely impede regulatory and legal enforcement, in part because such officials are frequently deeply embedded in local business circles (Wank 1999; Gilboy 2002; Wedeman 2003). Conflicts of interest, if not outright corruption – all of

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<sup>2</sup> Phenomena paralleling Marx’s notion of primitive capitalist accumulation.

which, by the center's own admission erode governmental legitimacy – are at least perceived to be rampant (Ding 2001; Hu 2002). Finally, the center's access to information often appears severely circumscribed, with considerable dependence for data collection placed on local officials who themselves face major incentives to distort, embellish, and dissemble.<sup>3</sup>

Though the details may be country specific, the general qualities of partial, halfway, and incomplete institutional development are hardly unique to China. Virtually any system undergoing change – which, in a sense, would include all systems – but particularly those engaged in explicit programs of reform and modernization at any given time exhibit institutions of a halfway or partially reformed nature. “Painted horses” flourish in systems understood by insiders and outsiders alike as being in a state of becoming. Yet, where do “painted horse” institutions come from, what accounts for their particular characteristics, and what prevents them from evolving into “zebras”? Why do reforming systems often get stuck in seemingly sub-optimal and inefficient institutional modes? Why do institutions in reforming systems end up the way they do?

### III. Reform Culture and Institutional Development

This study argues that the answer lies in a particular form of reform culture. The notion of culture employed by the study, however, is not an expansive one claiming to describe a given people's entire way of life (Geertz 1973), or even claiming that such a

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<sup>3</sup> The recent handling by the Chinese government of the SARS and AIDS medical situations at least in part reflected information problems within the system. On the academic side, debates regarding China's real growth rates, and inconsistencies between reported growth rates and reported energy consumption – among other indicators – have all turned on interpretations of the accuracy of Chinese reporting.

way of life can be said to exist. Nor is it about a rigid set of dictates, an orthodoxy that mandates specific institutional outcomes. Instead, this study uses “culture” in a narrower sense to refer a set of basic assumptions that individuals use, and that are shared societally, to make sense of a very specific realm of their environment, the realm of economic transactions. They are, in effect, assumptions about the way the world, or at least the economic world, works. Such assumptions can be understood as basic frames of reference (Swidler 2001), basic cognitive lenses for interpreting the empirical world, and fundamental principles of causality (Dobbin 1994) – intellectual constructs that permit individuals and groups to cope with and act upon situations of intense complexity and uncertainty.

This study argues that economic actors in China – both at the elite level in policy circles and at the grass roots level within firms – share a common set of principles about the way markets function, a common understanding of how causation operates in economic affairs. Just as we might think of a French style of industrialization in contrast to an American one (Dobbin 1994), or a British approach to deregulation as opposed to a Japanese one (Vogel 1996), so too can we think of a uniquely Chinese way of understanding markets. As subsequent chapters will illustrate, this unique understanding – discernable in the language that is used to discuss economic affairs, the manner by which economic actors describe their environment in interviews, and the explicit justifications policy makers provide for their actions – shapes the way economic problems are conceptualized and the types of institution-building responses that are attempted.

The point is not that individuals in China slavishly adhere to a particular economic orthodoxy, an ideology, or even what is generally understood as a particular economic school of thought. Nor is the point that debate over economic affairs is absent in China. To the contrary, economic policy and reform strategy are subjects of intensely rich debate and discussion in China (Fewsmith 1994; Fewsmith 2001). Bookstores, newsstands, and the television airways are packed with competing analyses of China's economic future and reform trajectory. Moreover, it is not just elites who engage in such discussions. Whether on the street corners, in their places of work, or in the privacy of their own homes, everyday citizens in China routinely discuss the economic reforms that have been sweeping their lives for the past twenty years (Dutton 1998; Barne 1999). Economic reform has entailed deep institutional reform, and deep institutional reform has entailed profound societal change. It is no wonder that debate, discussion, and competing opinions spill forth from all strata of society.

As this study argues, however, such debate, whether at the popular or elite level, takes place within a circumscribed intellectual space, one bounded by certain fundamental assumptions about the way causation in economic affairs operates. These basic framing principles, the essence of reform culture, provide the common reference points, common terms, and common meanings that are necessary for people to engage in discussion and debate. But, just as they facilitate debate, so too do they channel it in certain directions and narrow the range of options that are discussed. Similarly, so too do they limit and shape the range of possible actions people take when faced with economic problems. This is as true for elite policy makers as it is for grass roots economic actors. Reform culture does not suggest that people are somehow automatons marching

robotically in step with a particular economic ideology. Rather, it suggests that groups of people share common understandings about the way the world works and about the way causation operates. Those understandings, rather than being rooted in some sort of universal truth, frequently differ from society to society. These cultural frames of reference, while not in of themselves illogical or irrational, are in some sense idiosyncratic – they differ from the alternative conceptions of causation employed by people in other places or times. Such frameworks, rather than deriving from empirical observation, in some sense precede such observation, shaping the manner by which data are classified, ordered, and interpreted. The frameworks, then, can be understood as “shot in the dark” assumptions, principles that – for those who hold them -- may make sense, may be taken for granted as common knowledge, and may in some sense prove useful for negotiating the empirical environment, but that are not in themselves held up to serious analytical scrutiny. Culture, in this sense, is a tacitly employed lens through which complex information is ordered and acted upon.

The basic framing principles composing this lens, rather than shutting down debate or action, allow it to happen, but ensure that it will happen along some dimensions rather than others. That is, a given set of principles of causation will lead to a given palette of options for interpreting information and ultimately for acting. There is a “palette” in the sense that a wide range of options for interpretation and action is still available, but also in the sense that that range constitutes a bounded set, one different from the palette that might derive from an alternative set of basic framing principles.

Analogous approaches can be found in the work of both Frank Dobbin and Steven Vogel. As Dobbin notes, both American and French society in the 19<sup>th</sup> century faced

similar policy challenges surrounding industrialization, and both societies could be characterized by widespread contestation, debate, and intellectual ferment (Dobbin 1994). Yet, the French, even as they endured considerable societal change, and even as they cast about from one policy to another, consistently gravitated toward heavily state-centric solutions. Americans, however, facing many of the same economic problems and challenges, consistently opted for what today would be commonly termed market solutions, ones that sought to promote competition and free enterprise while limiting monopoly or other concentrations of power, whether public or private. As Dobbin argues, the French and Americans, while focused on essentially the same goal of industrialization – or more specifically, railroad building – had different understandings of the nature of the challenge, and different understandings about how given actions would lead to given outcomes (Dobbin 1994). Hence, debate may have been intense within each country, but the terms of debate differed across these places, as did the palette of policy options and solutions entertained by each country.

Similarly in the late 20<sup>th</sup> century, as Steven Vogel argues, the Japanese and British faced intense pressure – both from within and abroad -- to fall in line with global currents and engage in economic liberalization and deregulation (Vogel 1996). Both nations used the common rhetoric of liberalization and deregulation to discuss their respective reform programs. Yet, because these national cultures employed fundamentally different conceptions of how economic growth and markets operate, they ended up pursuing markedly different paths toward liberalization, paths different enough to make use of a single term like “liberalization” to describe both seem almost ludicrous.<sup>4</sup> While both

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<sup>4</sup> And indeed, when British or Americans observe Japanese-style liberalization, they deny it actually constitutes liberalization in any meaningful sense of the term.

Britain and Japan emerged with essentially freer markets (and a series of new rules to regulate those markets), Japan's liberalization reforms tended to strengthen or otherwise rechannel the state's capacity to manage and control the economy. Britain's reforms, on the other hand, effectively undercut the state.

Whether in the work of Dobbin or Vogel, or in the use of the term "reform culture" in this study, the argument is that common societal understandings of the way economics operates narrow the range of capacities that societies – and the individuals within those societies -- have for action. To the extent that these common understandings do so – to the extent they provide meaning and circumscribe capacities for action (Swidler 2001) -- they lead to the sort of routinized behaviors that effectively constitute social institutions. It is the argument of this study that in order to understand China's particular set of partially reformed institutions, and to understand China's persistent efforts to support those institutions even when to outsiders the costs appear unsustainable, one must understand the culturally-driven frames of reference that Chinese use to make sense of their environment.

### The Components of China's Reform Culture

As will be discussed at greater length in subsequent chapters, China's reform culture is composed of several taken-for-granted principles. First, and most basic of all is the assumption that the main impediments to growth in China are institutional. The understanding, in other words, is that China over the course of modern history fell behind economically, and to some extent remains so today, because its system was (and is)

inadequate. In order to achieve “catch up,” therefore, the system institutionally must be changed. When specific economic problems are encountered – be they related to slow growth, bank insolvency, enterprise failure, or deflation (or inflation) – they are attributed to something about the system and its institutional evolution, and then policy remedies almost inevitably grow out of some debate about what actually constitutes the appropriate institutional fix.

Because this particular perspective is employed not just within China, but throughout much of the world with respect to “transitional” or “post-socialist” economies, it is rarely challenged analytically or given much thought at all. It is certainly not treated as a “shot in the dark” assumption preceding rather than flowing from empirical observation, the very sort of assumption this study argues that it is.

For the time being, it should suffice to note that with respect to the case of Chinese “backwardness,” alternative principles of causation certainly have been proffered in the past, ones that in their heyday also happen to have been accepted as common knowledge. From the waning years of the 19<sup>th</sup> century to the present day, China’s intellectual and political milieu has revolved around a wrenching search for answers to the question of how a once great, absolutely dominant civilization could have fallen so dramatically behind (Spence 1990). Interestingly, the answer that so tragically prevailed for much of the 20<sup>th</sup> century, beginning with at least the May 4<sup>th</sup> movement in 1919 and extending through the wildest excesses of Maoism in the 1960s, was not the institutional one, but rather the “cultural” one. That is, the assumption was not that China’s institutions were deficient, but rather more profoundly, that the culture was sick, that the very Chinese individual himself – in spirit and mindset – had to somehow be recreated.

With this, the floodgates of social engineering were effectively thrown wide open. One need only peruse the titles of intellectual journals of May Fourth Era – *New Life*, *New Society*, *The Dawn*, *The New Woman* (Schwarcz 1986; Spence 1990) – or read the bitingly cynical stories of Lu Xun, particularly Lu’s description of his countrymen’s “Ah Q” mentality (Lu 1972; Lee 1987), to sense the depth of the social engineering impulse even early on, an impulse that would pervade Chinese politics and ravage Chinese society in succeeding decades. Well into the 1960s, China’s quest for modernity was not about tweaking economic institutions, or even engaging in wholesale institutional change. Instead, it was about fundamentally reshaping the Chinese individual and fundamentally remolding the Chinese psyche. And, of course, this essentially “cultural” explanation of China’s backwardness -- albeit without the passionate, almost evangelical political trappings -- extended well into mainstream Western intellectual circles with the works of Max Weber and others (Weber 1948; Weber 1968; Fairbank 1979).

The point is that while the institutional explanation of China’s economic problems may be plausible, it should be understood as but one of many possible perspectives, some more appealing than others. To many Chinese, and many outsiders for that matter, it has made sense since the early 1980s to attribute China’s economic problems to incomplete markets, inadequate rule of law, excessive state intervention, or unclear property rights – all essentially institutional explanations pertaining to a transition away from command planning. Decades ago, it made sense to Chinese and outsiders to attribute problems to Confucianism, “old” thinking, the conservatism of a peasant culture, or the “Oriental” mindset – essentially ethnic explanations. Beyond this, one could easily imagine tracing problems to historical issues of foreign intervention and conquest, domestic strife,

geography, or a variety of other factors, some of which are plausible, others less so, but all of which have been posited at one time or another as frameworks to explain “backwardness.” Interestingly, whether for good reason or not, none of these seriously enters the discussion of modernization challenges in China today. None is accepted as commonsense wisdom to the degree that the institutional perspective is. None even comes close to the institutional perspective in terms of framing discussions about policy alternatives.

Related to the overall institutional focus, a second component of China’s reform culture involves assumptions about the sorts of firms believed to drive economic growth. Since the inception of the first rounds of agricultural reform in the late 1970s, China has experienced an absolute burgeoning of entrepreneurship and new enterprise creation. Hundred of thousands of small to medium-sized firms have emerged, initially in the publicly owned collective sector, but increasingly in more fully privatized forms. The rise of such firms has – to varying degrees over time – received official approbation, particularly at the local level, and such firms are widely recognized as important sources of job creation. Nonetheless, for many Chinese, both within government circles and beyond, these entrepreneurial creations are viewed as anything but the fundamental motors of national growth. Instead, that role is assumed to belong to the nation’s large scale, vertically integrated, horizontally diversified industrial conglomerates. In this essentially Chandlerian vision, one that would have been equally taken for granted fifty years ago in most industrialized countries, large firms are understood to drive progress, and in so doing, are viewed as constituting the fundamental underpinnings of capitalism and modernity (Chandler and Hikino 1994; Penrose 1995; Chandler and Hikino 1997;

Nolan 2001). Small firms, from this perspective, are fine for providing jobs, supplying minor inputs or services, and serving a variety of other ancillary roles on the fringes of the economy, but the real action, the real locus of progress, and the real fount of creativity is to be found in a handful of large scale firms, key assets of the entire nation.

Whether one agrees or disagrees with the large firm focus, one can see how when combined with a set of additional assumptions, the view takes on a certain internal logic. Starting off, there is the plausible notion that over the long term, because of diminishing returns to basic factor accumulation, growth ultimately depends on productivity improvements. Productivity improvements, in turn, depend broadly on technological innovation – new tools, new materials, and new ways of doing things (Solow 1957). The next analytical jump, essentially a “shot in the dark” assumption, is that innovation in the modern industrial age stems from vast amounts of tacit knowledge accumulated over long periods of time. Such knowledge accumulation presumably exceeds the capacity of individuals, and can only exist within long lasting organizations. Know-how and creativity, in other words, rather than reposing in individual entrepreneurs, are instead understood as existing in massive corporate organizations, organizations that are somehow greater than the sum of their constituent employees. Individuals are talented, perhaps, but only by being situated in an organization and surrounded by comparable peers do they reach their full potential. Notions about diminishing returns to resource accumulation may drive the emphasis on technological innovation, but notions about increasing returns to knowledge and scale certainly drive the emphasis on the large firm and its association with modernity.

Flowing from this understanding is the assumption that as repositories of vast amounts of accumulated tacit know-how, key production organizations have an intrinsic value of their own, a value that somehow exceeds that of their constituent parts, and a value that somehow comes prior to that which is assigned by markets. In effect, such organizations come to represent the value of increasing returns to scale, scope, and knowledge. Individual employees may come and go, and market valuations may rise and fall, but the organizations, as repositories of knowledge and the only real producers of major innovation, somehow have intrinsic value. They are integral to the national growth process, and as such, must be fostered and preserved.

Just as the second component of China's reform culture pertains to the motor of economic growth, the firm, the third pertains – in effect – to the critical surrounding medium, the market. In China today, at elite and grass roots levels alike, there is unflinching faith in the power of markets to foster growth. The assumption, however, is not so much that markets foster growth through efficient allocation. They are not envisioned primarily as modes of allocation, selection mechanisms that continually deploy resources to some recipients and withdraw it from others (and, in the process, lead to the rise and fall of enterprises and other constellations of assets). Instead, the market is understood as a treatment, an incentive mechanism that when applied to existing organizations allows their intrinsic potential to surge forth and flourish. On the fringes of the economy, the market certainly induces churning as myriad small firms come and go, and myriad entrepreneurs attempt to grab newfound opportunities and rents. Fundamentally, though, at the core of the economy – the core at which policy is directed and from which national growth outcomes can be expected to derive – markets are seen

as a treatment, the latest and most modern instrument for unleashing the potential of modern industrial producers. Just as the modern large-scale enterprise is understood as having intrinsic value as a repository of organizational knowledge, such too are such enterprises understood as somehow preceding the market. The particular constellation of assets they embody does not represent some sort of market-induced allocation outcome, but rather precedes market forces.

It is with this in mind that Chinese policy makers talk about “exposing” firms to the market, and “enlivening” firms through market forces. The market, in this sense, by attaching value to inputs and outputs, and by permitting that value to be apportioned to stakeholders in the production process as a reward, serves as a basic incentive mechanism. Presumably, in this particular understanding of property rights, the producer – to the extent she enjoys the fruits of her labor and is held responsible for liabilities she accrues – will be induced to expand the assets under her control and create value. To the extent the market is truly in place, the incentives will all be aligned correctly, and she will be able to realize the full potential of her assets. Importantly, as noted before, the potential of these assets, and even their physical form (in terms of the boundaries of the firm, for example), are understood as factors preceding, rather than stemming from, the operation of the market. In China’s reform culture, then, the market is at once invested with extraordinary faith (faith that it will be the source of enterprise and national salvation), but also relegated to a rather secondary, instrumental status (a status subordinate to the modern industrial producer itself).

Taken together, these basic assumptions about economic causation have permeated China’s entire discourse of reform, and left an increasingly deep imprint on

the nation's institutional development. The impact will be discussed at length in the chapters on financial and enterprise reform, but can be summarized briefly. Virtually across the board, people in China now take it for granted that continued growth is inextricably linked to a continued process of "transition to the market," and concomitantly, that economic problems somehow stem from inadequate marketization. At the same time, elites and non-elites both tacitly accept what amounts to an economic hierarchy of enterprises, one stemming from assumptions about what type of firms fundamentally drive progress and which do not. Terms like "enterprise reform" (*qiye gaige*) and "financial reform" (*jinrong gaige*) are still understood to pertain to the "modern" (*xiandaihua*) sector, a select group of larger scale producers rather than the hundreds of thousands of small producers that populate the landscape. Smaller producers may be welcome, and they may be the positive artifacts of measures like agricultural decollectivization, fiscal reform, or governmental decentralization, but they are neither accorded the status of drivers of national development, nor showered with the attention in policy-terms of ostensibly "modern" industrial producers. The core of reform at any given time – whether it is framed in terms of the building of a "modern corporate governance system" (*xiandai qiye zhidu*), the separation of the ownership and regulatory functions of the government, or the reconstitution of the nation's financial sector, just to name a few – has always focused on the top tier of a pre-existing hierarchy of firms.

Interesting to note is that attention remains focused on top tier firms as the degree to which these firms are formally state-owned recedes. In other words, policy makers, in their now decades long quest to rejuvenate (*gao huo*) firms at the core of the economy, have of late shown surprising willingness to cede portions of ownership-based control.

While in the past it may have appeared that a pre-existing political pecking order (with state firms obviously at the top) drove economic policy, it increasingly appears today that it is an economic hierarchy of firms – an economic hierarchy derived from analytical understandings of the role these firms play in pushing development – that drives both economic and political policy.

That leads to a further ramification of reform culture. Because the basic expectation is that the market serves instrumentally to revive and rejuvenate the firm, the understanding when firm-level outcomes prove disappointing is that the market was somehow not fully or correctly applied. Debates, some mirroring similar discussions outside China, then follow both theoretically and in applied terms about what exactly constitutes a market solution. At the enterprise level does “marketization” entail full ownership transformation or just a government retreat from direct interference in managerial decisions? Should market reforms be applied gradually or quickly? Should interest rates and exchange rates be fully liberalized, partially liberalized, or left unchanged for the time being? How exactly should reform measures be sequenced? Does effective enterprise governance require better bank supervision, or should alternative channels of financial intermediation – namely stock and bond markets – be expanded?

These debates are intense and sophisticated. Yet, what remains essentially unchallenged is the premise that negative economic outcomes signal the failure or absence of markets rather than the normal operation of markets. By extension, what goes unchallenged is the notion that producers have an intrinsic potential that, with the appropriate institutional changes, can be unleashed. When that potential remains

untapped, the conclusion is – and has repeatedly been throughout the reform process – that the policies are bad rather than that the producer, in commercial terms, is somehow unviable. The alternative notion, of course, is that because these firms were built on expressly non-commercial terms and have no commercial value as currently constructed, their poor performance is an appropriate market signal that their assets must be redeployed. In other words, they must be shut down. Yet, that is not the conclusion generally drawn in China. Policy architects may debate what exactly was wrong with the policy, or what exactly it was institutionally about the old system that needs to be changed, but rarely is the conclusion that the producer itself is somehow unviable on commercial terms. Hence, when firms or financial organizations understood to be at the core of the economy perform poorly, policy architects go back to the drawing board, come up with a new set of reform measures, and in the meantime, bail out the financially distressed producers and their bank-dominated investors. The painted horses continue galloping along.

### Reform Culture and *Ideas*

It is important to distinguish reform culture from what are generally understood as “ideas.” In his work on the impact of Keynesianism on European policy making, Peter Hall argues that three factors shape the degree to which new ideas influence economic policy: economic viability (the extent to which the new ideas address prevailing economic problems), administrative viability (the degree of fit between new ideas, the established administrative practices of decision makers, and the administrative capacity

of the state), and political viability (the degree of fit between new ideas and the interests of dominant political and social groups) (Hall 1989). In the specific case of Keynesianism, Hall significantly refers to an additional factor, the “structure of political discourse” (Hall 1989). His point is that new ideas are debated within an existing “universe of political discourse” (Hall 1989), an existing web of meanings and cognitive associations particular to given societies. Such universes of political discourse – based on shared conceptions about the nature of society and the economy, shared notions about the appropriate role and scope of the government (Vogel 1996), and shared historical memories and experiences – provide the language and intellectual context within which new ideas and new policies are discussed and judged. They are, in effect, ways of ordering reality, cognitive lenses that are employed not just individually, but societally. Hence, as Hall notes, the term “planning” conjures up a different set of associations, and therefore takes on a different meaning, in France compared to the United States (Hall 1989). Similarly, ideas like Keynesianism, when interpreted and applied in a given national context, are done so within a specific web of pre-existing meanings and associations. Not surprisingly, the interpretations and applications then differ significantly from one society, one universe of political discourse, to the next.

China’s reform culture can be thought of along similar lines. The assumptions constituting this culture are not “ideas” *per se*. Rather, they are the pre-existing lenses, the pre-existing collective understandings of reality, through which new ideas are absorbed, interpreted, and applied. Ideas, in some sense, represent conscious attempts to cope with uncertain situations, arguments for why phenomena occur the way they do. As arguments, they are pitted against alternative ideas, and are recognized as such by those

either accepting or rejecting them. In periods of particular intensity, the ideas may coalesce and harden into rigid dogma and ideology, but even here, the adherents consciously recognize that they are taking a stand against alternatives -- heresies, in a sense (Comaroff and Comaroff 1991; Swidler 2001). Reform culture, though influenced by ideas over time, is not really about ideas *per se* or conscious efforts to evaluate ideas. Rather, it is about the constructs of reality through which new ideas must pass simply to be interpreted and discussed. Such primary constructs, made reflexively and unconsciously, are required simply to have a collective, conscious discussion about the second-order notions of causation and specific policy solutions offered by passing waves of ideas.

Reform culture operates prior to ideas in two respects: societally and cognitively. Social institutions -- the rules, norms, and practices structuring society -- have little if any concrete manifestation beyond the routinized behavior of people who populate them and "reenact" them in their daily lives (Dobbin 1994). Things like property rights, marriage, credit relations, and legal practices can, of course, be spelled out by legal codes, court decisions, and regulatory doctrine, but to the extent that such representations signify anything more than just information recorded on paper -- in other words, to the extent they really operate as lasting social institutions -- they need to mirror and shape observable social practice. As both descriptions of, and guides to, routinized action, they must in some sense embody commonly understood meaning for the people collectively performing the action, the individuals reenacting the circumscribed pattern. That is, collective, routinized behaviors -- the very sorts of behavior associated with social institutions -- require a degree of tacitly understood meaning among the individuals who

perform them. Culture, in essence, supplies these tacit understandings. During periods of relative calm and stability, individuals may tacitly absorb these meanings from generation to generation, basically taking the institutions as given (Hirschman 1977; Dobbin 1994). In more turbulent periods – times when unforeseen technological, demographic, economic, or geopolitical transformations seem suddenly to appear on the scene -- people in a more active and instrumental manner may question whether existing institutions still serve a useful purpose. When institutions appear to have lost their utility, people may set off upon searches for new answers to pressing challenges, new ways of thinking about relationships between action and outcome, and new ways of effecting purposive change – precisely the situation in China since the late 1970s. Still, even as people in such times wrestle with new ideas, those ideas must be discussed and absorbed within an underlying collective consciousness, a pre-existing universe of discourse. They must, in other words, pass through an existing cultural lens.

China's absorption of the particular intellectual wave that has dominated global economic discourse since the 1970s, the paradigm of free markets and deregulation, is a critically important example, one that will be discussed at length in subsequent chapters. China, like virtually any society, has been buffeted through the course of its history – particularly over the last 150 years – by various intellectual currents from abroad. Of all these – liberalism, fascism, nationalism, Marxism -- the global apotheosis of markets has arguably impacted most deeply. Indeed, the paradigm has been powerful enough to weave itself profoundly into China's reform culture. Just as Chinese policy makers, economic actors, and citizens more broadly have come to take it for granted that material outcomes hinge on institutional changes, so too do they now take it for granted that

progressive institutional change means “marketization,” some sort of linear movement away from socialist command planning.

Yet, what is interesting is that as this paradigm has worked its way into China’s fundamental political and economic discourse, it has done so in a decidedly different manner from that in other countries. In the United States and Britain, the market is generally treated as an end unto itself, one with almost moral force. The market is equated with efficiency, fairness, and objectivity. To the extent it is allowed to operate in relatively unfettered form, it is understood as permitting individual freedom and self-actualization. While governmental interventions may be necessary, they are just that – “interventions,” “departures from the norm,” actions that must be justified, judiciously weighed, and applied with caution. In China, the market may be equally appealing, but under entirely different, and entirely more instrumental terms. In other words, the global ideology of free markets and deregulation has been absorbed in China, but in a distinctly different manner from the way it has been absorbed elsewhere. In China, the market, market efficiency, market fairness, and market objectivity are not ends unto themselves, but vehicles for achieving collective ends, namely growth and national material enrichment. Markets are latched onto because they are assumed capable of unleashing the potential that exists in the system, primarily by transforming pre-existing firms into world-class competitors.

Here too we can observe differences from popular Japanese conceptions. As with China’s orientation toward the market, the Japanese have tended since World War II to understand markets as instruments for achieving national strategic aims – again, namely rapid economic growth. Yet, the Japanese assumption is that free markets are not alone

sufficient, but instead must be proactively managed, manipulated, and structured so as to serve strategic goals (Samuels 1994; Vogel 1996). Hence, there is – or at least was, in the heyday of Japanese economic growth – considerable societal discussion and debate about how markets can and should be complemented and transcended.<sup>5</sup> Governmental manipulation of markets did not require the sort of justification that comparable policies would have required in Britain, for in Japan, such manipulation was accepted as a matter of course. Interestingly, in China, while governmental intervention is rampant (and for numerous reasons, many of them expressly political), such intervention is not in the common discourse on economic affairs accepted today as intrinsically legitimate. In other words, Chinese reform increasingly throughout the reform era has come to juxtapose elements of highly divergent conceptions of markets. There is the Anglo-American faith that freer markets are ultimately better markets, but also the Japanese assumption that markets should be understood in terms of the achievement of national strategic aims. What is unique about the Chinese view is the faith that freer markets actually will instrumentally fulfill national aims. That is, purely in terms of economic causation, the Chinese assume not that markets need to be manipulated (though in practice markets are often manipulated), but rather that to the extent they are freed up, that markets will serve the combined national ends of building up core enterprises, building up national power, and generating national wealth.<sup>6</sup>

Within this particular universe of discourse, a variety of ideas can be discussed, considered and absorbed. The discussion is not about how much or to what extent markets should be manipulated, complemented, or sidetracked in order to achieve

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<sup>5</sup> A debate that played out in the literature on the developmental state.

<sup>6</sup> The fact of intervention – often driven by various political and bureaucratic issues – is different from the notion about economic causation that says that markets can instrumentally serve national ends.

exogenous national aims. Rather, because the assumption is that markets can bring the realization of such aims, the discussion turns to whether markets are actually being permitted to operate, and which strategy is best for allowing markets to do so. All manner of *ideas* about market causation can and are discussed, particularly with respect to specific policy dilemmas such as fiscal reform, banking reform, or industrial restructuring. For example, with regard to enterprise reform, debate both inside and outside policy circles has moved through a variety of ideas about what actually causes enterprises to perform poorly and what measures are required as remedies. Some have argued that the issue is primarily one of ownership, that somehow the fact that the *state* owns enterprises is a problem. In line with this reasoning, radicals have quietly pushed for privatization, but even mainstream policy makers emphasize the need to depoliticize the firm and separate the state's regulatory functions from its ownership responsibilities. At other times, the debate has shifted away from ownership, and instead focused on "governance," particularly governance in the sense of mechanisms to cope with agency problems between owners and managers. Here, debate has revolved around what exactly constitutes a "modern enterprise system" (*xiandai qiye zhidu*), whether such a system should fundamentally be bank based or stock market based, and how various stakeholders should be represented. At still other times, the debate has turned to issues of "rule of law" and the basic regulatory foundations of markets, the presumption being that their absence leads to enterprise failure.

Overall, a wide variety of ideas about causations are considered, and an equally wide variety of policy solutions – solutions flowing from the ideas – are attempted. What does not shift, however, is the basic underlying assumption that as long as markets are

functioning properly, core enterprises should thrive. Within the Chinese debate, there are supply-siders, and Keynesians, and monetarists, among others – all advocating competing notions of how markets operate and how policies should respond to specific problems. For all, however, when negative outcomes obtain – when growth proves elusive or core producers begin to crash – the basic assumption is that markets themselves were somehow not functioning. Each time negative outcomes obtain, the search resumes for new ideas, new answers to what exactly it is institutionally that underpins markets and allows them to function. Perhaps most important, each time this happens, enterprises get subsidized in the meantime, carried along until the ostensibly correct market solution can be determined.

The point is significant, for what it underscores is that reform culture is not just about discourse, but also – and perhaps most critically -- about action. In other words, it is not just a context in which ideas are discussed, but rather a guide to action, whether for the policy makers trying to create new rules or the basic grass roots actors engaging in economic activities and making managerial decisions. Reform culture, in this sense, constitutes what Anne Swidler terms a “repertoire” for action (Swidler 2001). People, be they policy makers or enterprise managers, cannot at every step carefully engage in means-ends calculations before acting. Rather, they follow certain established patterns, certain habitual, albeit complex, ways of orchestrating their activities. These repertoires do not determine the individual’s ultimate goals, but they do circumscribe the range of actions – the “capacities for action,” in Swidler’s terms (Swidler 2001) – that the individual will pursue to achieve those goals. Moreover, these capacities for action, because they stem from culture, should be understood not just in individual terms, but in

collective social terms. In the specific case of reform-era China, we witness extraordinary change, an extraordinarily intense intellectual engagement with new economic ideas, and extraordinary policy experimentation. At the same time, we witness a routinized response to economic problems, and a circumscribed capacity for action when policies fail to achieve their expected benefits. Certain core organizations, whether industrial producers or financial intermediaries, get bailed out. In the process, China's institutional architecture takes on a certain persistent cast, one generally described as "partially reformed" or "caught between plan and market."

That the principles of causation embedded within reform culture limit capacities for action emphasizes the degree to which such principles, though collective in nature, operate at the level of individual cognition. Economic activities, not to mention human affairs more broadly, are fraught with uncertainty. Simply to make sense of problems at the most basic level, and certainly to communicate that sense to others, assumptions, abstractions, and simplifications must be made about how the world – in this case, the economic world -- works. Indeed, our very notion of the "economy" is inevitably an abstraction, a carving out conceptually of a subset of human activities (Hall 1989), activities that are useful in intellectual terms to think of as distinct, but which in reality blend seamlessly with myriad other activities generally not considered "economic" (be they political, religious, familial, recreational, etc.). Such assumptions and ordering principles permit people to make sense of the torrent of data and sensory inputs attendant to even the most ordinary situations (Swidler 2001). They allow individuals to simplify, categorize, and otherwise sort data that along various dimensions could be considered either wholly alike or wholly unrelated. In effect, they permit the individual to draw

comparisons and analogies between distinct entities and across distinct situations, and as such, permit people to learn experientially and think analogically (Neustadt and May 1986; Khong 1992). In this sense, such principles, rather than deriving from empirical observation, precede such observation, and in fact enable it.

Frames of reference and principles of causality become particularly important in situations of uncertainty, situations in which the cognitive inputs are complex, and the potential modes of ordering and drawing causal connections numerous. In other words, a frame of reference is hardly pertinent to the individual's knowing that by releasing an apple from her hand, it will presently hit the ground. The same action will always and inevitably lead to the same reaction. The same cannot be said for decisions involving purposive action, or even just interpretation, under conditions of uncertainty. It is precisely such uncertainty that is characteristic of economic affairs and the operation of economic systems. The actual relationship between action and outcome is fraught with uncertainty, *ex post* let alone *ex ante*. On one level, people have coped with such uncertainty by turning to a range of theoretical perspectives – ideas, basically, about causation. Such schools of thought – Keynesianism, monetarism, liberalism, Marxism – carve out an intellectual space intentionally distinct from other explanations of a given phenomenon. At an even deeper, more tacit level, however, assumptions about ordering and causation must be made by the individual even just to consider those schools. Such “shot in the dark” assumptions, often couched in scientific terms and taken by those who employ them as laws of nature, permit empirical observation to take place, and equally important, permit individuals to evaluate competing explanations for phenomena that are not accepted as scientifically or naturally driven – phenomena that are accepted, in effect,

as “debatable.” Schools of thought like Marxism or Keynesianism provide competing answers to such economic phenomena, challenges like inequality, growth, or deflation. What schools of thought do not do is provide the even more fundamental leaps of faith, the even more basic assumptions that permit abstractions like “the economy” to be taken for granted as concrete entities, or that permit individuals simply to interpret complex situations and act. It is of these intellectual leaps of faith, leaps taken at both the individual and collective level, that reform culture is composed.

### Reform Culture and Instrumentality

Up to this point, culture has been discussed primarily in its tacit aspects. What must be recognized in the specific case of China, however, is the degree to which reform culture, for all of its tacit elements, also takes a decidedly up-front, center stage position in the life of virtually all citizens. Over the past century, Chinese society has lurched through a turbulent, often cataclysmic quest for what the Chinese themselves describe as “modernization” (*xiandaihua*). This quest has not just been about development and catch up *per se*. Rather, it has always been about recovering a rightful status, a deserving place in the world for a once-great, and disastrously fallen civilization. This mission -- whether expressed by nascent reformers in the dying days of China’s final dynasty (Kwong and Harvard University. Council on East Asian Studies. 1984), state-centric modernizers in the dawning days of Republican China (Eastman 1974; Duara 1988), devoted communists in the heyday of Maoist China, or economic reformers in the current era – is not just about top-down propaganda, the verbiage used to dress highly authoritarian

hierarchies of political power (though it certainly is in part about that). Instead, it is a mission, an entire discourse, that has permeated society in the profoundest ways, shaping everything from literature (Goldman, Social Science Research Council (U.S.) et al. 1977) and popular culture (Barne 1999), to education, environmental protection (Shapiro 2001), and labor relations (Lu and Perry 1997; Perry and Li 1997; Frazier 2002). The depth of the impulse is evinced by the great (and often catastrophic) movements of modern Chinese history – May 4<sup>th</sup>, The Hundred Flowers, the Great Leap Forward, the Cultural Revolution, and Tiananmen – all events of intense mobilization and voluntarism, and all inextricably linked to a collective struggle for modernity, however modernity happened to be defined at the given moment.

Through the course of this history, answers have been sought along all manner of guiding philosophies and ideologies: nationalism, democracy, “science,” fascism, and Marxism, among others. It is in this context, and along this philosophical progression, that the market has emerged as a conceptual anchor in contemporary China. Just as the tenets of democracy, or science, or Marxism were widely exalted and, arguably, truly believed in earlier periods (Nathan 1986), so too are the virtues of the market today. As with the earlier embrace of Marxism, that of markets is serious, committed, socially encompassing, and in some cases passionate. Yet, as with democracy, science, and Marxism, the intellectual embrace of markets is at heart instrumental. It is intrinsically instrumental, a solution to a collective search for modernity that in one way or another, possesses both salience (people are consciously aware of it) and legitimacy (it is seen as a solution to long-standing collective problems) across Chinese society.

The salience and instrumental legitimacy of the market have important ramifications for reform culture. First, while reform culture serves as a lens through which new ideas pass, it is also an up-front aspect of daily life, much more so than what are generally thought of as economic ideas. Elite debates on Keynesianism, deregulation, or capital account liberalization, though presented in the press, undoubtedly elude the general public in China, as they do in many other places. Yet, discussions of the market, and verbal associations between market orientation and modernity – whether directed toward an enterprise, a local district, or even an entire country – are routine in the daily social intercourse of the average citizen. Markets, their ostensibly positive instrumental function, and their equation with modernity have become part of everyday life in China, consciously presented as common-sense improvements over the thinking of the past.<sup>7</sup>

Second, reform culture, to the extent its constituent elements are understood as progress over past thinking, influences how people perceive their own interests and their role in society. An important example involves an issue discussed at greater length in subsequent chapters, contemporary labor relations. It is surprising to some observers, including this author, that China in recent years has had relatively low levels of labor unrest. More specifically, laid off workers frequently appear quite passive despite the fact that the country since the late 1990s has experienced a significant upsurge in urban unemployment. These layoffs large in absolute terms, but absolutely monumental relative to the “unemployment on the job” (Kornai 2000) maintained through the socialist era. No doubt, incidents of unrest have occurred, and, of course, many others have been

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<sup>7</sup> Which may explain both why the left is so weak in China, and why it attempts to gain purchase not through economic arguments, but rather through social arguments.

suppressed by state authorities. At the same time, as Marc Blecher points out, unemployed workers frequently seem to accept their fate lying down, showing none of the political activism characteristic of Chinese labor decades ago (Blecher 2002). This passivity, Blecher argues, stems from the workers' having accepted the core values, the intellectual hegemony, of the market and state. They view themselves as obsolete, as somehow legitimately cast into the dust by the onward march of progress. Hence, even the objective losers in reform, those whose promise of lifetime employment under the old system was suddenly revoked under the new, end up stating that "competition is right," or that market allocation of employment is both right in a moral sense and more efficient economically than the old system (Blecher 2002). At the very least, broad swathes of the population, even some individuals who appear to have lost everything, appear persuaded of the idea that "the market" is somehow better for society, and by extension, somehow better for their own children.<sup>8</sup> To the extent this is true, it has important ramifications for the government's legitimacy in China. To the extent citizens believe legitimate government is that which leads the nation toward modernity, and to the extent that modernity is associated with the market, China's government may prove more capable of weathering the economic vicissitudes of development than many observers imagine.

The overall point is that reform culture operates both tacitly as part of a general universe of discourse, and actively as part of a conscious societal drive toward modernization. Elements of China's reform culture bear similarities to a variety of sources: Marxist notions of surplus value, Maoist notions of mobilization and the potential of the human spirit, traditional Soviet notions of scale in industry, Japanese

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<sup>8</sup> This relates to a broader literature in economics on subjective well-being Graham, C. and S. Pettinato (2002). "Frustrated achievers: Winners, losers and subjective well-being in new market economies." *Journal of Development Studies* 38(4): 100-140..

notions of managed capitalism, American and European philosophical formulations of the market, among numerous others. Nonetheless, an explanation of the origins of reform culture, origins that are undoubtedly complex and multifaceted, is beyond the scope of this study. This study presents an argument not about the origins of culture, but rather about how culture shapes institutional continuity and change in a nation's political economy, particularly the political economy of nations undergoing the urgent drives toward modernity so characteristic of late development.

#### IV. Why Culture?

In studies of institutional development, cultural and ideational explanations, with some notable exceptions (Hall 1989; Berman 1998; Huntington and Harrison 2000; Blyth 2002; Swenson 2002), are frequently relegated to the peripheries, accorded a secondary status at best. As drivers of economic outcomes, they are viewed as nebulous and vague, particularly relative to ostensibly more concrete, measurable variables like economic interests and societal groups. Scholars may recognize intuitively that different societies seem to handle problems in different ways, and that these patterns may persist even in the face of tremendous socio-political change. Nonetheless, when it comes to pinpointing the evolution of institutional systems in strict analytical terms, the standard practice is to assume economic rationality, to assume that straightforward material interests constitute the base of the political economy. As Peter Hall notes, ideas – and by extension, the

cultural lenses through which ideas are integrated – are treated simply as “so much froth on the long waves of economic development (Hall 1989).

Given these established practices, why reach for the cultural explanation first? Why treat ideas and culture as the base rather than the superstructure of a political economic system? Why not just assume economic rationality and proceed from there?

In its emphasis on culture, this study argues that policy makers and other economic actors make “shot in the dark” assumptions to order reality and cope with uncertainty. Such assumptions then become critical in shaping overall institutional development and structure. What is important to recognize is that similar *a priori* principles of causation are adopted by scholars themselves as they go about studying institutions and institutional change. Like their counterparts in the policy world, scholars routinely make “shot in the dark” assumptions to order reality, assumptions about causation that make it possible to think about economic or political rationality and interest-maximizing behavior. That is, the notion that interests constitute the base of a political economy (and ideas or culture the mere superstructure) is built on an analytical foundation no sturdier – and indeed, as this study will argue in the Chinese case, empirically weaker – than that of the cultural perspective.

#### The “Transition” Perspective: Transition as a Path between Known Endpoints

To get a better sense of these standard scholarly assumptions, one might return to the allegory that began this chapter. That allegory, beyond just describing Chinese reform, expresses something fundamental about the way scholars approach institutional

change more generally. In much of the literature on post-socialist transition, and even on economic development more broadly, change – as in the allegory -- is understood as a movement between known endpoints. The questions worthy of study, then, are presumed to reside not in the endpoints themselves – ostensibly known institutional systems -- but rather in the journey between them (Kornai 2000). Particularly in the realm of transition, much scholarship presumes an understanding of how command planning operated, and equally presumes an understanding of how markets function, but then vigorously debates the means of getting from one system to the other. Arguments turn on the appropriate pace and sequencing of pro-transition policies, the most effective strategies for marshalling popular support for systemic transformation, and the degree to which a system has actually approached the final goal.

When intermediate institutions arise – the “painted horses” of the allegory -- standard analytical approaches offer two broad frameworks for coping with them. The first framework leans toward taxonomy, attempting to identify intermediate institutions with either one of the ostensibly known poles of the institutional spectrum. Optimal institutional change is understood as a progressive movement from the economic irrationality of the plan to the economic rationality of the market, movement along what amounts to a linear path of rationality.

[Insert Figure 1]

Institutions, in this view, are either on the optimal path, and thus will naturally reach the market endpoint, or they are not, in which case they should be treated as not

having begun the change process at all. That is, the reforming system is, by definition, understood as “partial,” existing somewhere on a spectrum between the poles of plan and market, but the question becomes which pole, in essence, the system is truly gravitating toward. Is the system partially reformed and well on its way to becoming a full-fledged market, or is it partially reformed because it is still essentially stuck in a mode of state-dominated allocation? Half-way institutions, in this light, either get dismissed as plain old horses in disguise – dressed-up versions of traditional command planning (Sachs and Woo 1997; Rawski 2002; Rawski 2002) – or lauded as nascent zebras, true market entities (McMillan and Naughton 1992; Overholt 1993). When reform has truly taken root and the system is understood to be on an inevitable trajectory toward the market endpoint, “painted horses” become mere ephemera on the path to economic rationality, stepping stones that ultimately either evolve into standard market forms or fade away into obsolescence.

From this perspective, the relevant questions for the Chinese case take on a similar cast. Are publicly listed SOEs in essence just traditional socialist firms, or are they incipient versions of something akin to public corporations in advanced industrial economies (Tenev, Zhang et al. 2002)? Should China’s stock markets be treated on similar analytical terms to those in advanced capitalist countries, or should they be understood as retrograde mechanisms of state allocation (Gregory, Tenev et al. 2000; Walter and Howie 2001)? Are China’s private firms *really* private, or are they some sort of offshoot of traditional state ownership (Wank 1999; Gregory, Tenev et al. 2000)? Do financial flows in the Chinese system follow the new dictates of competition and commercialization, or the far more traditional dictates of state plans and priorities

(Rawski 2002)? Foreign direct investment pours into China, but does it do so because outsiders have objectively determined that the system has marketized (and hence represents a stable investment opportunity), or alternatively, because foreigners know the system is distorted (in their favor) and hence seek to capture rents (Huang 2003)? Does China's transformation really constitute "growing beyond the plan" in brilliantly unorthodox fashion (McMillan and Naughton 1992), or instead a case of unorthodoxy leading to deferred, stalled, or otherwise unsustainable reform (Sachs and Woo 1997; Lardy 1998; Huang 2003)?

A second framework, while still conceptualizing transition as a movement between known endpoints, treats intermediate, "partially reformed" institutions as longer-lasting fixtures worthy of explanation in their own right. The first framework attempted to characterize institutions in terms of systemic endpoints. The second framework, however, recognizes – and seeks to explain why -- change can begin, go half-way, and halt; or, begin, and then somehow veer off the optimal path entirely.

[Insert Figure 2]

The key assumption is that persistent, entrenched intermediate institutions, since they clearly diverge from our understanding of what those at the final "market system" destination are supposed to look like, are by definition economically irrational. Indeed, it is here that the second framework really goes to work, for it aims to identify an alternative political or social logic to explain that which appears to defy economic logic (Bates 1981; Shirk 1993). The question becomes, "Why should reasonable men adopt

public policies that have harmful consequences for the societies they govern?” (Bates 1981). In other words, why build and perpetuate “painted horse” institutions that depart from economic rationality? The argument, in various guises, becomes that the people who build them are driven by explicitly non-economic factors. Such factors have included anti-market political ideologies (Lin, Ts'ai et al. 1996; Huang 2003), retrograde interest groups (Shirk 1993; Shleifer and Treisman 2000), social welfare preferences (Hall and Soskice 2001; Swenson 2002), and regime type.

Both frameworks, of course, say something descriptively accurate about systems in reform. Such systems, by the intent of those inhabiting them, are trying to move from one conceptualized starting point – a given set of institutions -- to another conceptualized endpoint, new institutions that better serve the needs of society. Moreover, such systems, through the course of change, frequently do exhibit institutions that somehow fail to achieve their stated ends – growth proves elusive, resources get wasted, and value gets destroyed.

Yet, beyond just offering description, such frameworks embody statements about causation, statements that, prior to empirical observation, tacitly posit certain notions of how the world works, while at the same tacitly dismissing others. Like the assumptions economic practitioners make about markets, the assumptions scholars make about economic rationality are intellectual constructs to make sense of the world, constructs that serve as lenses through which empirical observation is filtered. The lens of economic rationality does not dictate a particular explanation for institutional development, no more than reform culture dictates specific economic policies. What the lens does do, however, is to severely circumscribe the range of explanations that are

considered. As this study will argue, the explanations that are considered – the social and politic logics to account for economic illogic – are highly problematic.

With regard to interest-based approaches, virtually any institutional outcome can be identified *ex post* as beneficial to some societal interests and detrimental to others. Yet, in the actual unfolding of reform, whether in China or elsewhere, it has consistently proven difficult to determine *ex ante* which interests are strong and which are weak. Those who at a given time appear invincible – whether peasants, urban laborers, or local governmental officials in the Chinese case – have one by one fallen by the wayside and had their narrow interests undermined by new reform measures. Indeed, in the Chinese case, it is extraordinary the extent to which policy reformers have been able to run roughshod over a series of interests, each in their heyday believed inviolable. At the same time, as this study argues, certain patterns have persisted in reform policy – particularly in the financial and industrial sector – even as interests have come and gone. The evidence suggests that it is reformers who build coalitions of interest rather than coalitions of interest that build reform. Furthermore, as this study argues, the manner by which groups perceive their own interests may differ from society to society, given that assumptions about how actions lead to outcomes are particular to given cultures. The fallback position in interest-based arguments then becomes their pitfall – the tendency to argue that the strong always win, and that the winners are, by definition, strong.

A related approach attempts to link partially-reformed or otherwise sub-optimal institutions to regime type, the argument being that governments – especially authoritarian governments – resist changes that undercut political control. In the Chinese case, the argument is frequently made that though the regime seeks legitimacy by

promoting growth (ostensibly via the market), it resists the very forms of complete marketization that would undercut its political control and ability to serve politically powerful interests. Thus, the argument goes, to the extent the government remains authoritarian, or socialist, or communist, reform has always been, and will continue to remain locked in an incomplete, half-way institutional pattern.

Again, in a *post hoc* sense, the argument is plausible, for at any stage in reform, one could hypothesize that further reforms would erode governmental control. The problem empirically, however, is that at each stage in reform when this argument appeared plausible, the government took the next step further, thus eroding its traditional sources of control. Reform and its attendant institutional changes have, by definition, entailed an erosion of traditional forms of governmental control over resources. Command planning, after all, is a thing of the past. At the same time, the development of the market has placed increasing demands on the government to provide the public goods of market regulation.

In this context, “political power” itself becomes a problematic term, at least to the extent it is understood in unitary terms. Governmental aspirations to control are, arguably, omnipresent, yet highly unspecified across national systems. In some systems, control is understood as managerial and market enhancing. The governments that exert it push extremely interventionist measures through organizationally coherent bureaucracies. In other systems, where the market itself is understood as a virtue, control is exerted to lower barriers to entry, break up monopolies, and create new governmental bureaucracies to ensure fair competition. The question is not whether the government seeks control, but

rather what it thinks the appropriate means and ends of control are, and how it understands the causal relationship between its control efforts and economic outcomes.

Particularly in reforming systems, the interesting questions involve not the degree of governmental power – whether it is rising or falling – but instead the form of governmental power, whether it entails direct control over resources, or indirect forms of regulation. Moreover, the intent of power becomes critical. Is power directed toward undermining the market, or is it aimed at supporting the market? Are poor outcomes the product of excessive governmental efforts to distort market signals, or inadequate governmental efforts to provide basic regulatory support, factors such as basic property rights protection, enforcement of transparency rules, and protection of investors? In the case of China, political officials undoubtedly are concerned about power. At the same time, if power and control were the sole concerns, why would reform have been undertaken at all? If the answer is that legitimacy is also a concern, and that legitimacy depends on market-fostered growth, then clearly there is a more complex process going on, some sort of balancing between the competing imperatives of growth and power. As this study argues, it is at the very least worth exploring how officials and other actors understand those relationships, those relationships between political action and economic outcome.

While interest-based arguments have clear analytical weaknesses, a more important point involves assumptions scholars make, especially when studying transition, about the unitary nature of markets. In discussions of transition, assumptions of economic rationality presume some sort of movement between fixed systemic endpoints. At the very least, there is the presumption in the abstract of a linear slope of economic rationality against which empirically observable cases can be measured. That slope can be conceptualized only to the extent that the market destination is understood as clear and unitary.

Yet, if we put aside cases of transition, and instead turn toward discussions of developed systems, we find in fact that great debate still exists over what in institutional terms fundamentally comprises the market. In other words, the known endpoint in the discussion of transition suddenly becomes less-than-known once the debate turns to market systems more generally. The unitary nature of the market – its clarity as an institutional form – effectively disappears. The point is not that political economic systems, whether that of China or anyplace else, have the option of pursuing a “third way,” an alternative to either plan or market. The “market,” in some sense, is the only option for transitional and developing systems. Yet, what exactly is meant by the market? What, in essence, is the set of institutions that constitutes it? We understand what does not constitute a market -- administratively-set prices, planned allocation of investment, input-output plans for material goods, etc. – and it is clear that these institutions must be eliminated at some point in the transition to the market. Yet, what exactly should be built in their stead?

Even when the market option is understood as the only option, as it is in most systems effecting purposive change today, the exact nature of that option institutionally is quite uncertain in analytical terms. Are market systems in essence self-regulating, or do they demand an institutional foundation? How complex and extensive must that foundation be? Is its main purpose to protect market actors from the state, and thus avoid “politicization” and “government failure” (Boycko, Shleifer et al. 1995; Shleifer and Vishny 1998)? Or, is its main purpose to permit the state to protect economic actors from one another by addressing information asymmetries, and thus avoid “market failure” (Stiglitz 1994; Stiglitz 1998)? Taking even the most minimalist formulations in which the state exists just to provide basic property rights, what exactly constitute such rights in modern industrialized systems with complex producers? Are we talking about shareholder rights, and all the rules, regulations, and regulatory bodies that arise to ensure enough corporate transparency to make those rights meaningful? Are we referring to the extensive procedures and legal entities required to resolve situations in which property rights claims – namely those of creditors – overlap when property obligations, namely those of debtors, go unmet? Or alternatively, are talking primarily about restrictions upon the state – North and Weingast’s “credible commitments,” in effect (North and Weingast 1989)? Just what and how much is needed to make a system a “market,” and even more tricky, a “rational” market that presumably generates wealth?

Such questions have long been, and still are, honestly debated with respect to advanced market systems. Most important, how one answers those questions – how one assumes a market fundamentally works -- profoundly influences what one believes constitutes a rational and coherent set of market institutions. Depending on what the

starting assumptions are, one observer's "painted horse" might be another's "zebra." Those who assume that the fundamental source of economic failure in markets is the state will posit one set of institutions as a benchmark for rationality (Shleifer and Vishny 1998). Alternatively, as **Figure 3** suggests, those who assume that economic failure stems primarily from information asymmetries and agency problems between market actors – problem that must be remedied through state intervention – will posit a quite different set of optimal institutions (Stiglitz 1998).<sup>9</sup> The point is not that correct answers are unattainable. Nor is the point that every institutional setup found in developed market systems is economically acceptable or effective. Many are not, and lead to stagnation, crisis, and other socially destructive outcomes. Rather, the point is simply that sophisticated debate persists about what it is that makes even the healthiest market systems – those most nearly approaching textbook models -- healthy. That it does suggests both that analytical uncertainty exists and that proponents of various sides of the debate set off with entirely different *a priori* assumptions about how markets function.

[Insert Figure 3]

Such analytical uncertainty about developed markets makes characterizations of economic incoherence in transitional or developing systems highly problematic. These

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<sup>9</sup> In addition, considerable differences of opinion exist regarding the exact nature of the command system, and the nature of variation across real-world examples. Numerous scholars have argued that specific aspects of China's pre-reform economy made the task of reform in China substantially different from that in the former Soviet Union Qian, Y. Y. and C. G. Xu (1993). "The M-Form Hierarchy and China Economic-Reform." *European Economic Review* 37(2-3): 541-548, Naughton, B. (1995). *Growing out of the plan : Chinese economic reform, 1978-1993*. New York, NY, Cambridge University Press, Sachs, J. D. and W. T. Woo (1997). "Understanding China's Economic Performance." *NBER Working Paper No. w5935*, Qian, Y. Y., G. Roland, et al. (1999). "Why is China different from Eastern Europe? Perspectives from organization theory." *European Economic Review* 43(4-6): 1085-1094..

characterizations – based on a presumption of a unitary reality for market institutions -- in one fell swoop assume away all the analytical debate and uncertainty that surrounds the operation of markets in the real world. An illusion of certainty is created, certainty about the nature of what reforming institutions *should* ultimately look like, and certainty about the extent to which many of these currently reforming institutions *are* economically irrational.

#### The Development Perspective: Exchange Schools vs. Production Schools

The previous discussion suggested that in studying transition, scholars, like their counterparts in the policymaking arena, make *a priori* assumptions about the institutional foundations of markets. In the specific context of post-socialist transition, where the market is understood as the ultimate destination, this particular set of assumptions is central. Yet, at an even broader level, when the discussion turns to general issues of economic development, uncertainty about the market constitutes but a small subset of the overall analytical uncertainty that scholars and policymakers routinely cope with. Such uncertainty relates not so much to the nature of markets, but rather to the nature of the relationship between markets and development. Do markets fundamentally drive development or impede it. Should purposive institutional change really aim to create markets, or alternatively, should it aim to transcend markets?

This question relates to an empirical puzzle that has long driven the field of development economics, the apparent failure nations to converge economically (Sachs and Warner 1995). As Dani Rodrik points out, nearly two-thirds of the world's

population lives in countries where per capita income is less than one-tenth that of the United States (Rodrik 2003). Moreover, the income gap between the world's richest and poorest countries has widened rather than narrowed since the age of industrialization. On the whole, rich countries in the modern era have grown far faster than poor countries (Romer 1986), and cases of catch up have been few and far between. Indeed, they are exceptional enough to merit special study and consideration (World Bank. 1993; Amsden 2001). Why has convergence failed to materialize? Why are cases of catch up so rare? Why should the rich be able to achieve higher growth rates than the poor?

As economic theory has evolved over the past two centuries, scholars have offered two broad ways of thinking about these questions, two schools based on essentially antithetical sets of assumptions. One school, focusing on what Maurice Dobb terms "relations of exchange" (Dobb 1973), emphasizes the degree to which markets and their key signaling mechanism – price -- drive development. In this view, growth is all about facilitating the free exchange of goods and service. Relations of exchange – markets – pertain to neutral, natural, objective forces, ones removed from the particulars of any society or culture. To the extent that prices are freed up to reflect supply and demand, and exchange is permitted to proceed uninhibited, the expectation becomes that growth should proceed spontaneously. Growth, in effect, is understood as the product of nature, a natural path of least resistance.

A second school, emphasizing "relations of production" (Dobb 1973), understands growth not so much as a product of nature, but rather as a transcendence of nature by society. Economic outcomes are believed to be contingent upon particular socio-economic conditions in a given society, whether property rights, relations between

social classes, or governmental policy. In this view, growth is achieved neither by allowing markets to operate unimpeded, *per se*, nor by letting *nature* run its course. Relations of exchange are understood not as natural, but rather as embedded in social factors. Moreover, the key toward directing those relations toward growth-producing outcomes is believed to lie not in “freeing up” natural forces, but rather in building particular mechanisms of societal organization, whether political, military, or legal.

For the exchange school, the notion that growth flows from markets – and that economic convergence among nations should be expected to happen naturally – flows from a series of linked, plausible, and generally untested *a priori* assumptions. First, there is the assumption that basic factors of production will seek their highest marginal returns. In effect, they will migrate to precisely those areas where they are scarce – where demand is great, supply is low, and price, presumably, is high. Second, and related, there is the assumption that basic factors over time suffer diminishing returns to scale. Taken together, the first and second assumptions suggest that unless otherwise impeded, factors like capital and skilled labor should flow naturally from rich countries – where supply is already high, and diminishing returns are setting in – to poorer countries, where demand is intense and potential returns extremely high.

Third, there is a critical assumption is that information, particularly information about how to make things – technology, in effect – is perfect. That is, the knowledge of how to produce things, be they goods or services, is assumed to flow unimpeded from the rich to the poor. The assumption recognizes that, ultimately, growth is contingent on productivity improvements (a notion that flows from the idea of diminishing returns to basic factor accumulation), and productivity improvements are contingent upon

knowledge, new technologies, and innovation. Yet, what the assumption says is that while the rich countries may be expected to pioneer and develop these innovations, the innovations will ultimately flow to the poor. They will flow in large part because they are presumed to be codifiable – they can be specified, written down, and effectively presented much as a recipe would be in a cookbook.<sup>10</sup> Indeed, it is not just technology *per se* that is understood in these terms, but also the entire knowledge of how to apply technologies to the making of things. Production, in this view – whether of cars, steel, software, or t-shirts -- is tantamount neither to art nor craftsmanship. It is not about learning to paint like Michelangelo. Rather, it is about straightforward labor – painting by numbers. Taken together, these powerful assumptions about factor mobility, diminishing returns to scale, and perfect knowledge suggest that capital and technology should all flow into the developing world, with the end result being not only that poor countries grow, but that they grow faster than rich countries.

That convergence has failed to occur hardly ends the discussion. Instead, what is most important about the exchange school (as will prove true for the production school as well) is its assessment of why convergence has failed to occur. The exchange school – or more accurately, the disparate theories employing its assumptions -- offer a vast range of explanations for arrested development. For all their differences, though, they agree on one point -- that markets produce growth, and concomitantly, that the absence of growth in one way or another reflects the impeded operation of markets. Beyond this, however, the theories range outward in a variety of directions.

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<sup>10</sup> There is a growing literature on the issue of codifiability Baldwin, C. Y. and K. B. Clark (2000). Design rules. Cambridge, Mass., MIT Press, Aoki, M. and H. Takizawa (2002). "Modularity: Its Relevance to Industrial Architecture." paper prepared for the "Conference on Innovation within Firms," The Saint-Gobain Centre for Economic Research.

Among exchange school scholars focusing on the state, some argue that exchange is impeded by government intervention and politicization, be it through politically-induced price controls (Bates 1981), barriers to trade (Sachs and Warner 1995), impediments to market entry, or state ownership of producers (Boycko, Shleifer et al. 1995; Shleifer and Vishny 1998). In other words, the state is too big, and too intrusive. For other scholars, however, the state in slow developers is criticized for being too small, or at least too incapable. This camp asserts that exchange is impeded because of inadequate mechanisms to deal with the cascading agency relationships – and concomitant information asymmetries and monitoring problems – associated with modern economies (Stiglitz 1998; Stiglitz 1999). Presumably, it is the responsibility of the state to provide these mechanisms, essentially regulatory public goods. This camp may not be terribly concerned about assumptions of perfect knowledge when it comes to production, but it is interested in challenging the idea of perfect information with respect to complex stakeholder relationships and monitoring in modern industrial settings (Berle and Means 1968).

Among exchange school scholars focusing on the connection between property rights and development, we again witness a variety of perspectives. One view suggests that property rights are critical for getting incentives right, and that in order to get incentives right, the power to exert control over an asset must be combined with the power to claim residual returns from that asset (Grossman and Hart 1986). Property rights in this light are all about fixing a title against potential challengers, whether from other economic actors or the state. When growth fails to obtain, the conclusion becomes that control and cash flow rights were not sufficiently fixed and concentrated to induce

people to invest productively in their assets, as opposed to, say, engaging in rent seeking and expropriation (Boycko, Shleifer et al. 1995). An alternative view, however, suggests that property rights are critical not because they concentrate control and cash flow rights, but precisely because they do the opposite – they permit multiple owners to enjoy claims to a fixed asset. In other words, they permit material assets to be converted to liquid capital through the disbursement of cash flow rights to distant claimants (Soto 2000). Basically, an owner can get cash today by promising creditors a claim on the asset tomorrow. This view says that poor countries remain poor not because the incentives are wrong, but rather because poor people – due to unspecified property rights – are unable to convert their material assets into capital. Capital, in effect, is insufficiently liquid, and therefore insufficiently agglomerable. Presumably, because people cannot take out mortgages on their homes or put their land up as collateral for loans, they personally -- and their societies more broadly -- prove unable to agglomerate resources and devote them to more productive uses. People end up rich in assets, but poor in capital (Soto 2000). Whether the arguments are right or wrong, what is interesting is the extent to which even from within exchange school assumptions, the operation of something as central as property rights remains subject to such divergent opinion.

Finally, on the exchange front, there is wealth of new scholarship on the sociological foundations of markets. From this perspective, growth fails to obtain because somehow the fundamental social glue believed needed to make markets function proves insufficient or utterly absent. In other words, exchange is understood perhaps as natural, but still contingent on non-economic factors like trust and social capital (Putnam, Leonardi et al. 1993; Fukuyama 1995; Locke 2002). The rich, from this perspective, get

richer because their societies are endowed with social capital -- the “trust, norms, and networks, than can improve the efficiency of society by facilitating coordinated actions[.]” (Putnam, Leonardi et al. 1993). Scholars argue whether such capital -- the social glue presumably needed to ameliorate the agency problems of market-based exchange -- is historically determined (Putnam, Leonardi et al. 1993), culturally determined (Huntington and Harrison 2000), or buildable through purposive political action (Locke 2002). Nonetheless, the basic underlying assumption is that markets, when surrounded with the appropriate social norms and networks, should -- all things being equal -- result in growth. When growth fails to occur, the search begins for the impediments to market function.

The production school, of course, is also interested in sociological explanations, yet its assumptions, and its overall framing of the questions, are entirely different. For theories of the production school bent, non-convergence, rather than being a puzzle *per se* is actually the expected natural outcome. Indeed, it is the relatively infrequent phenomenon of “catch up,” developing country growth vis-à-vis the developed world, which is deemed worthy of explanation. Again, the basic assumptions, the basic principles of causation, are critical.

First, in addition to the basic idea that factors seek their highest marginal return, there is the assumption that modern industrial economies entail increasing rather than diminishing returns to scale. The presumption, in other words, is that modern production necessitates intensive use of capital, technology, and knowledge. To the extent this is true, factors of production, if permitted to seek their highest marginal returns, will migrate toward areas where minimum scale economies have already been surpassed – the

developed world. Hence, liberalized market pricing becomes not the friend of the developing world, but rather the enemy.

Second, there is the assumption not only that technology and innovation are necessary for development, but more important, that the knowledge behind such innovation is anything but perfect. Knowledge about production, from this perspective, does not flow, and cannot flow. It does not flow in part because those who possess it, companies in the developed world, do all they can to impede its flow to potential competitors from the developing world. To the extent that cross-border cooperation occurs, the global leaders ensure that key pieces of proprietary technology and process innovation remain under their own control. They may share bits and pieces, but they never give up the keys to the kingdom.

More important theoretically, this view argues that even if developed world competitors were willing to pass on their knowledge, they could not, for the knowledge itself is inherently uncodifiable. It is, in effect, intrinsically tacit and extraordinarily subtle. Production, in this line of thinking, really is something akin to art. In effect, to produce competitively, to produce in a way that really embodies innovation and productivity gains, one must truly be the equivalent of a Michelangelo. One can read books on painting, and even buy paint by numbers kits, but fundamentally, the only way truly to get ahead is to paint repeatedly, “learn by doing” (Amsden 1989), observe what the leaders are doing, and effectively come up with one’s own unique style so as to do it better. Since knowledge is at best only partly codifiable and transferable, one must fill the gaps by aggressively and consciously innovating, presumably as much through process innovation as product innovation.

Third, the assumptions about increasing returns to scale (both for capital and knowledge) and the tacit nature of production knowledge, when taken together, lead to an assumption that in order for growth to proceed, society must be purposively organized in such a way as to create innovation. That is, if relations of exchange are allowed to run their natural course, skilled people will migrate to existing clusters of expertise, thus ensuring that innovation will remain focused in the developed world. Alternatively, if prices could be distorted through purposive action -- if expertise and capital, in effect, were rewarded above their natural market clearing price – then the problem of increasing returns to scale could be tackled. Societies could purposively build scale economies.

Equally important theoretically, production schools, rather than treating innovation as something arising spontaneously from the ether, consider it a phenomenon worthy of serious investigation, and one inextricably linked to particular kinds of organization. Innovation is believed linked in knowledge-terms to scale economies, and such scale economies are associated with big production organizations. The idea is that organizations to varying degrees embody organizational knowledge, the very sort of tacit knowledge noted earlier with respect to innovation. Such tacit knowledge extends far beyond the individual, achieving its highest returns when concentrated and focused geographically. Hence, the phenomenon of skilled individuals – engineers, scientists, doctors, etc. – choosing to leave the developing world (where their skills are presumably in short supply) in order to begin new lives in developed countries (where scale knowledge economies presumably already exist, and compensation – along with fulfilling professional opportunities – are high)(Easterly 2001). Again, the point is that innovation

requires organization, and organization, rather than arising spontaneously through natural forces, must – at least in poor areas devoid of scale economies – be purposively built.

Within the production school, difference of opinion exist regarding the nature of innovative organizations. Some scholars view these primarily as large firms, massive production organizations that have the accumulated experience, internal organization, capital, and skilled personnel needed to pioneer innovation and pursue new markets. Other scholars, however, focus more on extended communities, networks and regional economies encompassing groups of firms and producers (Saxenian 1994; Locke 1995; Segal and Thun 2001; Saxenian, Motoyama et al. 2002). The idea here is that knowledge economies can be understood to exist just within the individual large firm, but rather across associations of multiple producers, entities like industrial clusters, science parks, and Silicon Valley-style clusters. The overall point, however, is consistent. Whether individual firms or extended communities, innovative organizations must be purposively built, and when they are built, their whole – their collective tacit knowledge, their experience, their know-how – is somehow greater than the sum of their parts.

Also within the production school, scholars differ on the mechanisms required to transcend natural processes of exchange. One perspective places substantial emphasis on the state, particularly policy efforts on the part of the state to distort market prices. Here, the interventionist state does not just provide market-supporting institutions – mechanisms to cover agency problems – but also aggressively manipulates prices so as to achieve strategic aims (Amsden 1989; Wade 1990). Costs of capital are pushed downward, salaries for scientists and engineers are pushed upward, and public funds are pumped into research. State programs push technology transfer, reverse engineering, and

process innovation. Extensive public-private cooperation is promoted, whether through direct state ownership over firms or substantial state funding of private concerns.

Governmental bureaucracies are purposively intertwined with, and deeply embedded in, national scientific and business circles. Catch-up becomes synonymous with state-led development.

An alternative perspective, while retaining the emphasis on purposive action, stresses more bottom-up processes, ones emanating as much from civil society as the state itself. Here, perhaps not surprisingly, the emphasis is less on massive companies as innovative organizations, and more on extended communities and industrial clusters. The general point is that cooperative behavior – relations not just of trust, but also purposive innovation – can be promoted through business associations, independent industry standards boards, joint management-labor partnerships, and other groups that can either complement or somehow transcend unfettered market competition (Locke 2002).

There are several noteworthy aspects of the exchange-production distinction. First, though the two schools embody markedly different perspectives on development, their essentially irreconcilable assumptions are routinely mixed, matched, and confusingly combined in academic discourse. For example, within the exchange school, advocates of the minimalist state accuse advocates of a more regulatory-inclined state (presumably to cover agency problems) of being anti-market, or of presuming that the “helping hand” of the state can transcend markets. In fact, advocates of the straightforward regulatory state generally understand markets as the key to development, but also assume that a basic regulatory apparatus is necessary to make markets function. The “helping hand” view is much more akin to the production school perspective, one

that downplays the role of regulation in facilitating market function, and emphasizes the role of regulation in transcending markets.

The broader point is that academic debate has for whatever reason tended to revolve around the “state versus market” distinction, one that fails to demarcate unreconcilable notions of causation about how development happens. Plenty of believers in the notion that markets induce development envision a substantial role for the state. Similarly, plenty of believers in the notion that markets – if left to their own devices – impede development, have little interest in top-down, state-sponsored remedies. Arguments about minimalist or maximalist states are more often than not second-order debates about policy instruments. More fundamental, however, are the first-order assumptions about causation – assumptions about the forces that drive development – that precede these debates. Unfortunately, these assumptions, and the important distinctions between them, remain unexamined in the shadows.

Along similar lines, self-described advocates of market-led development frequently stress the need to “get incentives right,” presumably via market-determined prices, but at the same time acknowledge that increasing returns to scale operate in knowledge economies (Easterly 2001). In other words, on the one hand, they argue that prices need to be freed up and markets depoliticized so that people in poor countries have an incentive to engage in asset expansion rather than rent-seeking. Yet, on the other hand, by recognizing increasing returns to scale, they effectively acknowledge that freed up, market-determined prices – in this case, salaries – will lead to an outflow of skilled people from the developing to the developed world. The remedy, presumably, involves some sort of benign suspension of market prices, possibly through salary subsidies for

engineers or the devotion of public funds toward the building of industrial clusters. That then undercuts the idea that development is primarily about freeing up markets. An argument that began with one logic ultimately ends with another.

Whether regarding the role of the state, the nature of incentives, or the function of price, uncertainty obviously surrounds our analytical understanding of the basic causal mechanisms behind development. That such uncertainty exists, and that such a range of informed opinions exists about development, underscores the problematic nature of the concept of economic rationality – the notion that universal economic truths exist and have been identified, and concomitantly, that divergences from such truths represent the intervention of non-economic factors.

This then leads to a second point about the exchange-production distinction, one pertaining to the social institutions that as noted earlier, embody various notions of economic causation. It is no surprise that given the analytical uncertainty surrounding economic development, the social institutions that seek to realize it vary immensely. In a fashion analogous to exchange versus production debates, institutions within a single national system may represent a diverse and – from the perspective of outsiders – inconsistent – set of assumptions. For example, even in fully developed market systems, we can observe a wide range of bankruptcy rules and Chapter Eleven-style provisions (Carruthers and Halliday 1998). Some favor creditors by speeding the process by which an insolvent firm is placed in receivership and liquidated. Others favor debtors by suspending debt obligations for the insolvent firm, allowing insider managers to remain in control, and shielding the debtor from liquidation. From the exchange school perspective, pro-creditor policies are presumably favorable, for they minimize price

distortions, speed the process by which assets (those constituting failed debtor firms) are placed back in circulation, and facilitate the exchange-based “creative destruction” from which innovation is believed to emanate. Alternatively, from the production school perspective, pro-debtor policies are arguably preferred, for they protect organizations that have over time accumulated vast reserves of tacit knowledge and achieved economies of both scale and scope. Similarly, in the United States, a country that prides itself on its free market credentials and entrepreneurial spirit, we find a variety of tax policies favoring large corporate organizations, not to mention an immense defense budget funding large contractors, at least in part, through cost-plus arrangements -- hardly hallmarks of unfettered competition.

Many have argued that these odd combinations of institutions, institutions that seem to embody contradictory principles of causality, must derive from an alternative logic of societal interests. The problem, however, is that for individuals or groups to understand what is in their own interest, they must have some sense, some expectation, of how economic action will lead to economic outcome. As the discussion of the exchange-production school distinction illustrates, though, great uncertainty surrounds precisely these sorts of expectations, whether at the individual or national level. People cope with uncertainty by making a priori assumptions, assumptions that underpin expectations about future outcomes. Such expectations, then, guide action. As this study argues, such expectations, at least in some sense, can be understood as collectively held, thus leading to the sorts of repeated collective behaviors and social practices that constitute social institutions. That the institutions vary across societies and often appear confused or sub-optimal is undeniable. Yet, this empirical reality does not ipso facto confirm that such

institutions have departed from economic rationality. Indeed, institutional diversity across societies, and the persistence of seemingly sub-optimal institutions within societies, signifies not so much a departure, but rather a search for economic truth. That truth, whether with regard to the nature of markets or the relationship of markets to development, has proven extraordinarily elusive. With each collective stab at an answer, institutional forms emerge, some impressively effective, others woefully inadequate, but all signifying waypoints on mankind's as yet uncompleted quest for economic truth.

China's reform culture, of course, shapes that quest in one particular country at one particular – and particularly dynamic – period of time. Just as the principles of exchange and production get confused and play out in odd ways in developed market systems, so too do they get confused in developing systems. Similarly, just as China's reform culture represents an effort to cope with the uncertainties of transition, so too does it represent an effort to cope with the broader uncertainties of development. As will be discussed in the specific chapters on financial reform and industrial policy, China's reform culture embodies principles of causation that glide back and forth between the exchange and production perspectives. In their faith in the redemptive power of markets, Chinese policy makers appear squarely in the exchange school camp. At the same time, in their assumption that enterprises precede markets, and that incumbent organizations have intrinsic organizational value, they veer toward the production school. In their recent and much heralded efforts to push “comparative advantage” strategies of development – a strategy embodied in the 2001 WTO accession agreement – they return to exchange principles. Yet, their concurrent strategy of pillar industry development smacks of production school thinking. China's reformers, in their historically-driven

determination to “catch up” globally, have the ambitions of the production school, yet they have chosen, with equal determination to employ the instruments of exchange. The following chapters will be devoted both to demonstrating the logical thread that Chinese policy makers use to square this circle, and to illustrating the problematic patterns of institution building that emerge as a result.

#### IV. Conclusion

Institutional development in China’s financial and industrial sectors is a topic worthy of study in its own right. China, whether in terms of its own consumer markets or its status as a production shop floor for others, is becoming an increasingly critical component of the global economy. China’s economic growth, however, as with virtually every other developing and developed economy, hinges on how effectively it can foster particular kinds of institutions, ones that can support markets, cope with agency problems, encourage innovation, and manage the state. The challenges are arguably most immediate – not to mention most complex – in the interlinked financial and industrial sectors, the topic of this study.

Yet, this study aims to be about more than just a single country, however important. Rather, in focusing on a particular notion of culture, this study is about how all of us, scholars and practitioners alike, frame our world, and how those framings represent serious efforts to cope with the as yet unresolved mysteries of complex human

interaction. In the academic world, we accept at value that scholars are searching for answers as to how societies can achieve material enrichment, the sorts of enrichment that permit greater general welfare and the basic freedom to pursue a variety of additional aims, whether material or otherwise. Yet, more often than not, we do not accept at face value that policy makers and other actors in the real world are engaged in the same search. Instead, we frequently ascribe their actions to narrow self interest or blind participation in the will of a broader group. Somehow, human agency – agency in a serious sense – disappears from the picture. This is all the more true when the institutional outcomes of policy choices appear sub-optimal, precisely the case in situations of “partial” reform. The following chapter, however, attempt to take agency seriously. They attempt to take seriously the idea that practitioners, to a degree no greater or less than that of scholars, are engaged in an honest quest for answers, answers for maddeningly complex and uncertain situations. As observers, we may – and perhaps should – lament that real world institutions so often appear to be painted horses rather than zebras. The reality, however, is that more often than not, we – scholars and practitioners together – have yet to define in anything but vague abstractions what “zebras” really are. This study is fundamentally about that ongoing search.

Figure 1. Post-Socialist Transition: Economically Rational Institutional Change

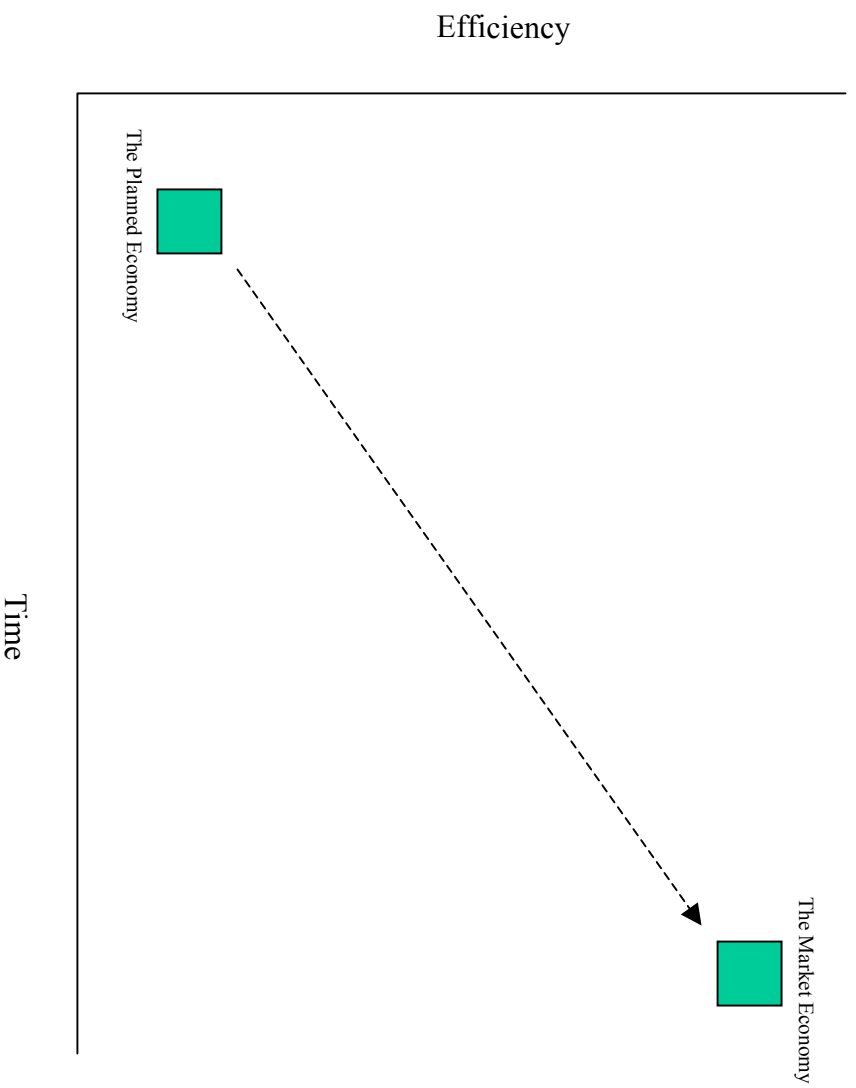


Figure 2. Post-Socialist Transition and Divergences from Economic Rationality: Alternative Political Rationalities

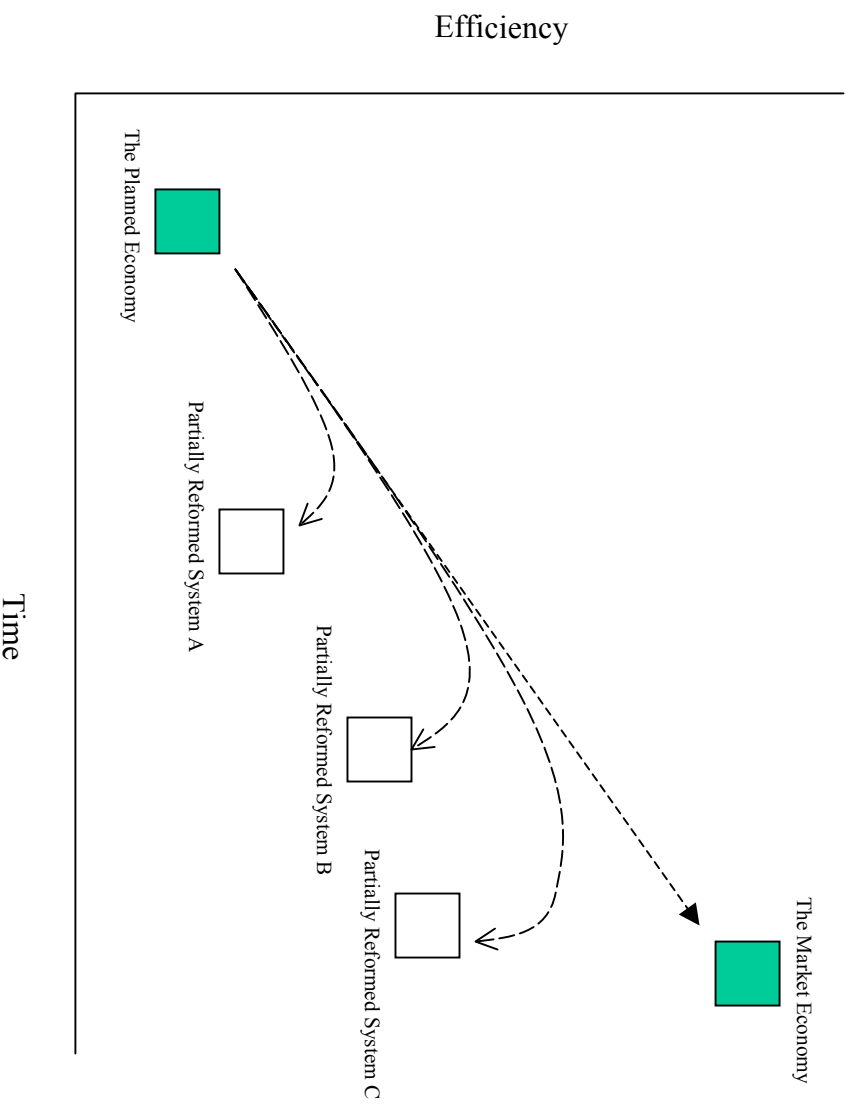
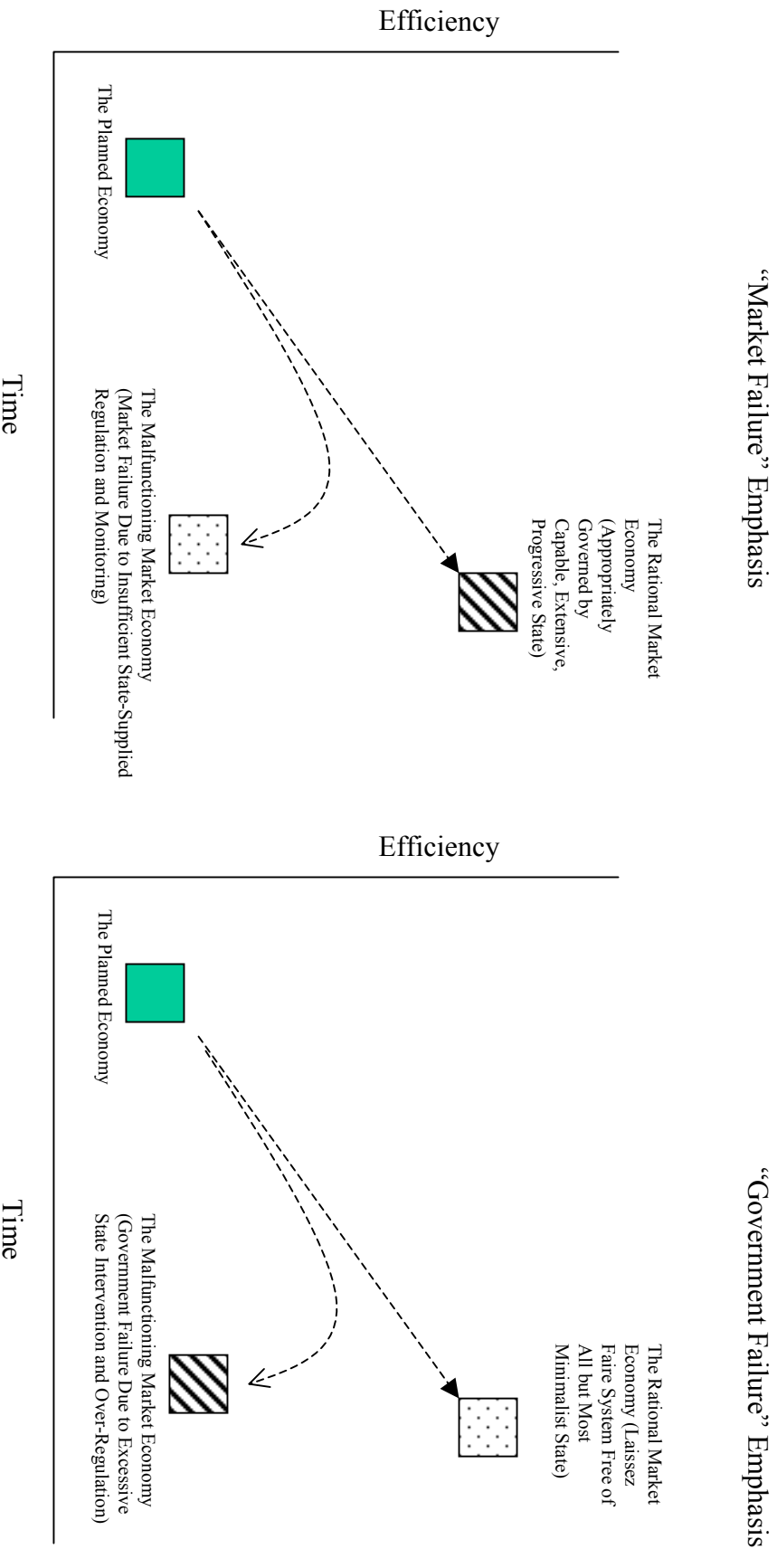


Figure 3. Alternative Notions of Rational Post-Socialist Transition: Which Path to Rationality? Which Market Endpoint?



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