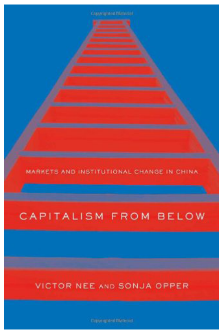
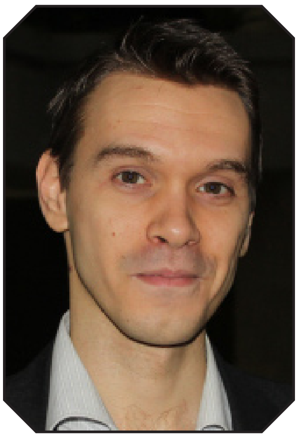
NEW BOOKS

Alexander Kurakin

Explaining Economic Growth in China: Testing Sociological Tools for Validity



Book Review: Nee V., Opper S. (2012) *Capitalism from Below: Markets and Institutional Change in China*, Cambridge, MA: Harvard University Press.



KURAKIN, Alexander Alexandrovich — Lecturer, Faculty of Social Sciences, National Research University Higher School of Economics. Address: 20 Myasnitskaya str., Moscow 101000, Russian Federation.

Email: akurakin@hse.ru

Today it makes little sense to ask why social scholars would be interested in China's economy insofar as the answer is obvious. The growth rate of the Chinese economy and the duration of its growth period are stunning. It is likely that in the near future China will outrun the US in terms of GDP and will become the largest economy in the world. Moreover, China has made huge progress in GDP per capita. But this is not the only reason to be interested in China. Notably, the communist party is still in power there, and by the standards of Western democracies, China remains an authoritarian state. Taken together, these characteristics form a paradox: How could communists produce such huge economic growth? The recent history of socialist countries seems to show that this is impossible. Although the Soviet Union sometimes demonstrated rapid growth, it could not sustain the pace in the long run. In the Chinese case, we face a more fundamental phenomenon than just the mobilization of a country to achieve vital objectives (usually with high costs).

"Capitalism from Below: Markets and Institutional Change in China" by Victor Nee and Sonja Opper suggests the answer to this question [Nee, Opper 2012].

Keywords: capitalism; economic growth; state; entrepreneurship; institutions; China; new institutionalism.

Theoretical controversy

The general target of Nee and Opper's criticism is the state-centered approach to economic development, according to which the state is the key actor in economic development because it establishes the institutions that promote economic growth. From this perspective, China is no exception, as the central government and local administrations are considered to be the engines of market transformation. China's economic miracle is thereby perceived as the outcome of efforts by the state to build the necessary institutions.

The authors argue that this model is not entirely relevant to the Chinese case. While they do not deny the role of the state completely, Nee and Opper emphasize that the key factor behind China's economic growth is not the state, but rather a bottom-up development grounded in social norms and networks. "Our argument is that the bottom-up construction of endogenous economic institutions has *causal priority* over state-mandated rules and policies in explaining the rise of China's private enterprise economy" (p. 16).

The authors claim that China demonstrates the reverse logic of economic development: at first, economic actors at the micro-level forged efficient informal institutions (based on social norms) and only after these informal institutions emerged did the state adjust to this newly created market economy and change the formal rules. Moreover, very often the state tried to slow down the development of private business, despite the fact that it was the state that initiated economic reform. At the first stage of the reform, the Chinese central government perceived the private sector only as a supplement to the socialist economy and hence sought to restrict it to playing a peripheral role. Private firms were tolerated, rather than supported; only small household firms were openly encouraged.

The government began formal registration of private firms with more than seven employees beginning in 1988, i. e., ten years after the first economic reforms were launched. By then, the private sector already made up a sizeable part of the Chinese economy, which is to say that, from the very beginning, it developed in confrontation with the formal rules. Not only that, private firms suffered from predatory taxes and insecure property rights, including the danger of expropriation by local government. It was not until 2007 that the Chinese Property Rights Law, extending equal rights to the private sector, was enacted.

Yet, official acknowledgement of the private sector did not lead to state support of it. Indeed, the Chinese state favored collective socialist enterprises and discriminated against private firms. For example, 443 different approvals were required to register a private firm in the period from 1988 to 2007 [Yang 2004]. The highest tax rate for collective enterprises was 55%, while for private firms it was 86%. Unlike collective enterprises, private firms had no access to start-up capital from the state. Private firms were discriminated against with respect to export licenses, access to production material and skilled workers. They were the object of various production quotas and restrictions. Quite often, private firms were perceived by local governments as cash cows. The state extensively protected collective enterprises from competition by the private sector. In sum, the market economy in China had to evolve in quite a hostile environment. Nevertheless, a very efficient market economy emerged in China.

Nee and Opper claim that a state-centered approach that argues that economic development is forged by favorable formal rules implemented by the state cannot be applied to the Chinese case. "Despite the absence of formal rules safeguarding property rights of the capitalist enterprise, the emergence and diffusion of cooperation norms at the micro level enabled entrepreneurs to commit to a private enterprise economy and allowed them to survive outside the state-owned manufacturing system" (p. 9). The authors argue that Chinese economic growth rests on the bottom-up activity of market actors who use social tools to enhance efficiency, namely informal institutions emerging from existing social norms and dense networks. "Informal economic arrangements enabling, motivating, and guiding start-up firms provided the institutional foundations of China's emergent capitalist economic order" (p. 8). But how was this possible? What mechanisms made this bottom-up activity so fruitful? It is insufficient just to name informal institutions, social norms and networks. The book is about discovering those mechanisms.

Research focus and theoretical assumptions

What were the problems that needed to be resolved by start-up firms to achieve success in such uneasy circumstances? The authors list them as: a lack of economic institutions to protect economic transactions, collective action problems, weak property rights, and competition with government-owned firms that benefited from most-favored treatment in the state's industrial policy (p. 8). The authors present the challenges in economic terms, but give a sociological response to them.

Nee and Opper introduce a theory of endogenous emergence of institutions as a theoretical framework. They propose a multilevel causal model of institutional change which combines three levels: macro-level of state structures, meso-level of firm networks and market organizational fields, and micro-level of actors.

The nature of institutions is described as follows: "We define institutions as systems of interrelated informal and formal elements — customs, conventions, norms, beliefs, and rules — governing social relationships within which actors pursue and fix the limits of legitimate interests" (p. 17–18). The authors borrow Thomas Schelling's model as the core explanatory tool for the study and interpret it sociologically [Schelling 1978]. In this way, the book addresses both economists and sociologists. At this juncture, we recall the interview that Victor Nee recently gave to our journal, in which he mentioned several times the importance of doing work that earns recognition outside of one's own professional community (*Ekonomicheskaya Sotsiologiya*, vol. 15, no 2, pp. 144–153; vol. 15, no 3, pp. 169–178). The very composition of the book suggests that his own research meets this challenge.

Empirical data

The authors rely on various evidence to support their premise of the ambiguous role of the Chinese state in economic transformation. The book is based on two surveys, taken in 2006 and 2009. The project is still in progress and for more detailed information we refer to the web-page of the book and project[1]. Here we just mention that the empirical data were obtained using a seven-city sample in three provinces of the Yangzi delta region. The region was chosen by design, as it is considered to be a center of entrepreneurial capitalism in China, allowing the authors to regard it as a kind of a natural laboratory.

The research combines quantitative data and informal interviews. Two stages of the quantitative survey (in 2006 and 2009) yielded more than 700 questionnaires from private firms. Panel data were collected, making it possible to trace any changes in respondent's answers. As expected, some of the respondents at the first stage did not participate in the second stage, but the authors managed to keep the majority of the panel. In addition, during 2005–2011 the authors collected 111 face-to-face interviews with entrepreneurs, officials, and researchers. Taken together, the book is complete with not only statistics, but with vivid life stories as well.

Mechanisms of bottom-up economic growth

The book seeks to reveal mechanisms applied by Chinese entrepreneurs to build from the bottom-up institutions that enabled efficient economic performance.

How did firms obtain initial capital, overcome insecurity of property rights, and learn the art of running a business? The authors reveal the following major mechanisms which helped to solve those problems: personalized exchange, mutual dependence, information sharing, the key role of reputation, mutual monitoring and community sanctions. The newly created private firms gained legitimacy through mimicking already existing organizational forms sanctioned by the state. A number of other mechanisms for fixing particular problems (for instance, getting access to credit or skilled labor) are described as well. Those rules were forged through a process of trial and error. Many pioneers quickly failed, but they tried again and were followed by others.

Informal rules cannot emerge from nowhere, they need dense social networks. In China rules creation takes place in industrial clusters, which provide far more than just reduction in transportation costs and easy access to human capital and information. "The spatial proximity in cluster locations provides fertile ground for the

1 See: http://www.capitalism-from-below.com/ (accessed on 22 September 2014).

social processes necessary for the bottom-up development of business norms sustaining trust and cooperation... Personalized exchange and multiplex business relations provide the social glue, strengthening norm compliance and promoting cooperative forms of conflict resolution within robust networks" (p. 160). Spatial proximity of actors in industrial clusters fosters the emergence of appropriate rules. Effective norms are created in close-knit business communities. Those clusters help to establish a common identity, local knowledge, trust and norms of cooperation. This leads to the establishment of sustainable supply chains, access to distribution networks, and entry to domestic as well as global markets.

The diffusion of cooperation norms arise from social learning (i. e. following the example of one's relatives and friends), learning on the job, and mutual assistance and cooperation (even among potential competitors, as the norm not to compete with your friends exists). At some point, it becomes a self-reinforcing process: the more actors follow the norms, the more influential the norms are.

Taken by itself, this story provides no grand theoretical insights. "Because you can only cheat once" — these words of a respondent are used several times in the book and they hark back to James Coleman's (and many others) social capital concept and his study of Jewish diamond merchants in New York City [Coleman 1988]. However, as Nee underscored in the interview mentioned above, robust findings that have external validity are more important than an original and sophisticated theory in the form of an orienting framework. The authors undoubtedly managed to produce robust findings.

We forego a detailed description of the mechanisms briefly mentioned above, and instead continue with an overview of how the book has been received until now.

Reviews of the book

What has been the effect of "Capitalism from Below"? In his 2013 interview with our journal, Prof. Nee only mentioned the early feedback because the book had just recently come out. The book has since captured the attention of the wider social scientific community and has been reviewed by a number of eminent scholars. All reviewers highly appreciated the book; we discuss here the more critical feedback in order to reveal the polemics on the controversial issues and we omit reviews that focus on retelling the main ideas of Nee and Opper's book (see [Gohmann 2013; Xuebing, Hui 2013]). As one could easily guess, the main point of contention is the role of the state in the Chinese economic miracle.

One of the first reviews of the book was written by Doug Guthrie, an expert on China. A substantial part of his review is devoted to Victor Nee and his interdisciplinary position in the social sciences. This position leads sociologists to view him as an adherent to the market-oriented approach and the invisible-hand concept. Yet, to economists, he appears an advocate of organizational theory in the style of John Meyer and Brian Rowan [Guthrie 2012]. Guthrie calls the book a "fabulous capstone" to the literature on the Chinese economy, although he does not completely agree with its conclusions. Guthrie argues that behind the economic incentives that stimulate the entrepreneurial creation of institutions lies a specific strategy of the state. According to Guthrie, state experiments at the local level are by no means less important than entrepreneurial innovations. Therefore, Guthrie finds it strange that the authors believe that one side of the coin (entrepreneurs) is more important than the other (state)

The book by China specialist Andrew Wedeman [Wedeman 2012] surprisingly correlates with Nee and Opper's book. In "Double Paradox: Rapid Growth and Rising Corruption in China" Wedeman seeks to answer the question, how the economy and corruption could grow simultaneously. Conventional wisdom suggests that they are incompatible. But Wedeman argues that the example of China shows that economic growth under widespread corruption is possible. Despite Wedeman's state-centered approach, the book shares common ground with “Capitalism from Below” in that Wedeman, like Nee and Opper, poses a similar question, although his answers differ. While Wedeman focuses on the state, by assessing the efficiency of anticorruption campaigns and conceptualizing Chinese corruption as “transactive” rather than “degenerative”, Nee and Opper suggest that corruption has limited influence on the private sector, as it evolved relatively independently from the realm of state officials. The interconnection and contradiction between “Double Paradox” and “Capitalism from Below” are noticed by Andrew Nathan in his review for “Foreign Affairs” [Nathan 2012].

Wedeman himself reviewed “Capitalism from Below” [Wedeman 2013]. Generally he appreciated the book, especially the carefully collected empirical data and some results concerning certain business practices in the Chinese private sector. According to Wedeman, the main shortcoming of Nee and Opper’s book is the rosy picture it paints of the Chinese private sector. Wedeman argues that Nee and Opper portray Chinese entrepreneurs as upright, honest and hardworking which does not fully resemble his own view of Chinese business. He also criticized the authors for the book’s scant treatment of corruption.

Yin-wah Chu underscores that “Capitalism from Below” “will remain a key reference for a long time” [Chu 2013:. 701]. However, she argues that the book lacks consideration of the broader sociocultural environment, including state actions and the global diffusion of capitalist practices. Chu notes that Chinese entrepreneurs “have hardly invented the capitalist institutions”, so Chinese institutional development cannot be described as an exclusively bottom-up movement [Chu 2013: 701]. Chu also suggests that more attention be paid to the artisanal and commercial traditions of the Yangzi delta. Chu argues that, taken together, those arguments could weaken the theory of endogenous institutional creation.

Neil Fligstein claims that “Victor Nee and Sonja Opper’s book has opened up an intriguing new version of China’s development story, one that is certain to be a subject of admiration and debate” [Fligstein 2013: 554]. He does, however, criticize the authors’ interpretation of the empirical data, noting that survey respondents are inclined to paint their actions in bright colors when they are talking about their own firms. Fligstein also draws our attention to other shortcomings of the book. For instance, he argues that the book lacks a detailed description of the concrete linkages between the state and markets. As a result, descriptions of Chinese industrial clusters often resemble stories from the literature about Silicon Valley. Finally, Fligstein expectedly points out that the role of the state in Chinese economic development is underestimated. If we recall how Fligstein links the rise of Silicon Valley with actions of the US government, his view on the socialist economy in China will become more or less clear [Fligstein 2005]. Visiting Yiwu City, described by Nee and Opper, Fligstein describes feeling the influence of the government almost everywhere in the city. According to Fligstein, it is an undisputable example of a developmental state in action.

Marshall Meyer cites the manufacturing crisis that struck China in 2010–2011 [Meyer 2013] as an anomaly that cannot be explained by the capitalism-from-below theoretical framework, and he draws several conclusions from this. First, exogenous factors cannot be excluded from bottom-up development. Second, bottom-up capitalism is resistant to governmental aid. Third, a loose coupling of the formal structure with real processes in the firm in order to gain legitimacy could have a negative effect in the long run.

Two reviews of Nee and Opper’s book appeared in one issue of the journal “Contemporary Sociology” alone. John Lie and Julia Chuang challenge the main thesis of the book, starting with the quite provocative title: “The Withering Away of the State in China?” [Lie, Chuang 2014]. The reviewers question the book’s broad claim that market and state are mutually exclusive channels of resource allocation in a society. In China it is more accurate to talk about hybrid public-private organizations than about pure images of a market or a state. Moreover, Lie and Chuang stress that Chinese entrepreneurs are embedded in global capitalism, which undermines the argument of exclusively endogenous economic growth. Finally, they, like Fligstein, point to the limitations of the survey data, as entrepreneurs tend to exaggerate their own role and to minimize the role of the state. In this regard, the reviewers refer to the book by Yasheng Huang, who examined the same region as Nee and Opper but painted a very different picture [Huang 2008]. Lie and Chuang see the reason for that gap in the different empirical data: Huang's study is based on archival documents.

The other review in "Contemporary Sociology" was by Andrew Walder who criticizes Nee and Opper's statement that the entire literature on Chinese capitalist development stands on the position that economic growth is impossible without proper formal institutions [Walder 2014]. Unlike Nee and Opper, who characterize that literature as state-centered, Walder suggests tying it to political economy. This literature is not limited to the analysis of central state legislation but pays much attention to the actions of grassroots government officials who played an important role in the early stage of Chinese private sector development. Walder reminds that, along with bottom-up private firms, there are newly created top-down government-owned corporations in China. These giant firms are the successors of huge socialist enterprises, and Walder calls this sector "bureaucratic capitalism". Such corporations enjoy monopolistic or oligopolistic positions; they hold a substantial share of assets and employment; and finally, they do not compete with the private sector, as they occupy different product niches. (State corporations dominate in strategic sectors such as banking, mining, heavy industry, energy production, civil aviation, etc.)

The informal economy, China and Russia

Two more questions naturally arise from reading "Capitalism from Below". The first concerns the informal economy. The second (at least for Russian readers) regards parallels with the post-Soviet transition in Russia.

At first glance "Capitalism from Below" may seem a story of tensions or at least independent existence of formal and informal economies. Inefficient, corrupt state pushes potential entrepreneurs in the informal sector. Telling the story in that way makes it similar to Hernando de Soto's argument about his native Peru [Soto 2002]. Perhaps, it is the most widely known study of informal economy praising the agents of free market forces who are able to overcome all the barriers made by state. De Soto argues that hiding in the shadow economy result from lower transaction costs. Indeed, "Capitalism from Below" has some common ground with de Soto's "The Other Path".

Nee and Opper's story of China differs from De Soto's of Peru in two respects. First, the activity of the majority of Chinese private firms generally does not violate the existing laws. Without a doubt, it is very hard to expect that everybody will comply with the laws when those laws are clumsy and uncomfortable, but nothing like the "second economy" of the Soviet Union or the parallel informal sector of Peru emerged in China. While for De Soto informal activity means avoiding costly formal rules (taxes, licenses etc.), for Nee and Opper informal activity means, above all, creating the informal rules of the game. Moreover, in many cases, the informal rules are not in competition with the formal rules, as the latter are absent or apply only to the state sector.

Second, in "Capitalism from Below", the key role is played by social forces, while they are absent in De Soto's argument. The discourse about the role of social factors in informal economic activity has a long history. For instance, opposition to De Soto's approach, to some extent, caused Alejandro Portes to formulate his first paradox of the informal economy concerning social ties [Portes 1994]. "Capitalism from Below" supports Portes' argument.

Parallels with Russia are apparent as well. China, like Russia, experienced market transformation. In Russia it happened in the form of shock therapy while in China it took the form of light liberalization. And we see substantial difference in the outcome.

While generally not the intention of the early reforms, state capitalism, dominated by state corporations and huge enterprises, emerged as the economic model in Russia. Agrarian reform is a good example here. Large collective farms were meant to be transformed into numerous private family farms, whereby farmers were expected to become key actors in the agricultural sector, but to this day, the role of family farms remains minimal. Furthermore, recently we witness the emergence of huge, vertically-integrated agroholdings that act hand-in-glove with local authorities. Farming is just one sector where Russia failed to create any substantial bottom-up entrepreneurial movement.

Using Nee and Opper's logic, the Russian transition economy lacked those natural entrepreneurial clusters with a dense network structure and "proper" social norms. Nicole Biggart and Mauro Guillen use the example of Taiwan to draw attention to the extensive network structure of Chinese society and its importance for economic activity [Biggart, Guillen 1999]. They also argue that every society has its specific social structure and norms and therefore has an individual trajectory of economic development. "Capitalism from Below" provokes similar conclusions. According to its logic, the Chinese way does not suit Russia. Russia lacks a China-like social basis with its norms and networks. These features were largely missing at the outset of market reforms.

Finally, we offer one last note about the role of the state in the economy. Comparing China and Russia is very useful here. As previously mentioned, Nee and Opper deliberately do not place the state at the center of their analysis. They also leave aside the role of the state in law enforcement. Indeed, law enforcement is usually perceived as something to take for granted. But the Russian case contradicts that conventional wisdom. The newly emerged Russian state appeared weak, particularly when it failed in its role as regulator of the economy during the first transition years. This gave rise to criminal organizations that began making up their own rules of the game. Vadim Volkov calls this phenomenon "violent entrepreneurship" [Volkov 2002]. The Chinese government managed to keep the levers of regulation in its hands, and thus made it possible for entrepreneurs, not criminal organizations, to create informal economic institutions. Criminal groups in China were excluded from establishing rules of the game on the scale in which it happened in Russia during the 1990s.

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Received: September 8, 2014
Citation: Kurakin A. (2014) Explaining Economic Growth in China: Testing Sociological Tools for Validity. *Ekonomicheskaya sotsiologiya = Journal of Economic Sociology*, vol. 15, no 4, pp. 107–114.