CENTER FOR THE STUDY OF
Economy & Society

Department of Sociology
327 Uris Hall
Cornell University
Ithaca, NY 14853-7601

CSES Working Paper Series

Paper #1

Victor Nee

"Organizational Dynamics of Institutional Change:

China's Market Economy"

September 2001 (revised, October 2003)

ORGANIZATIONAL DYNAMICS OF INSTITUTIONAL CHANGE: CHINA'S MARKET ECONOMY

Victor Nee
Cornell University

September 2001
Revised, October 2003

* This paper is adapted from my chapter in the Economic Sociology of Capitalism, edited by Victor Nee and Richard Swedberg (Princeton: Princeton University Press 2004).
I wish to gratefully acknowledge research assistance provided by Wubiao Zhou. My gratitude to Rachel Davis, Sonja Opper, Alexei Waters and Geoff Woodley for providing useful comments and careful readings of the manuscript.

Transitions from state socialism offer rich natural experiments allowing for a better understanding of the dynamics of large-scale institutional change in newly emerging capitalist economies. Market transitions entail the shift from one distinct institutional form to another. In a state socialist redistributive economy, goods and services are allocated through central direction by nonmarket means. By contrast, in a market society, decentralized market exchange serves as the main mechanism that allocates goods and services. There are of course ideal types, which economies in the real world may combine to some degree. In this essay I examine real world institutional transformation in an economy undergoing a rapid shift from central planning to reliance on markets. Through the theoretical lens of new institutional economics and economic sociology, I examine the ongoing organizational dynamics in China's industrial economy shaped by the rapid emergence of hybrid ownership forms and private enterprises and persistent displacement of the market share of state-owned firms. I show that Douglass North's (1990) theory of institutional change encounters difficulty in accounting for the organizational dynamics of large-scale institutional change because it assumes that organizational actors respond unproblematically to incentives stemming from changing relative prices. A more adequate explanatory account of the dynamics of institutional change, I argue, integrates hypotheses from economic sociology explaining the structural inertia facing organizational actors and the emergence of oppositional networks and norms limiting the scope and direction of transformative change.

North's theory of institutional change assigns to the state a central role. His starting point is a neoclassical theory of the state, which assumes that states exchange the provision of security and justice for revenue from their constituents, and devise property rights to maximize this revenue. North's theory argues that states are constrained in their revenue maximizing activity by competition with other states and political rivals; hence, they have an interest in structuring property rights that will secure the support of constituents against possible rivals, including other states and competitors within the same political order. North's theory offers two important insights into the role of the state in large-scale institutional change. First, when rival states threaten the state's survival and force "the choice of extinction or of modifying the fundamental ownership structure" (North 1981: 29), rulers are confronted with powerful incentives to initiate institutional innovations aimed at devising more efficient property rights to improve economic performance and to better compete with their rivals in inter-state competition. Second, institutional innovations will come from states rather than constituents because the state does not have a free rider problem, whereas individuals and organizational actors are limited in their capacity to implement large-scale changes due to the problem of free riding.

A still more fundamental mechanism of institutional change in North's theory is changing relative prices, which arise from changes in the ratio of factor prices (e.g. cost of labor), changes in the cost of information (e.g. stemming from the internet), and changes in technology, especially military technology. In North's view entrepreneurs act as agents of change and organizational actors as the players who respond to changes in relative prices in order to adapt to enhance survival and profit-making. An example of the latter is the rush of manufacturers from advanced capitalist economies to China to take competitive advantage of its huge supply of skilled low-cost compliant labor. Manufacturers facing intense competition in the global economy are irresistibly drawn towards skilled Chinese labor eager to work two full days for the price of one hour or less of an American or European or Japanese laborer's time. As a result, even long-standing institutionalized commitments to local labor—in the Japanese case, lifetime employment—are altered, in order to gain marginal profits otherwise not attainable.

Thus North's theory turns on two clusters of causal mechanisms: the market, with the incentives stemming from changes in relative prices, and the state, as a revenue maximizer, devising, initiating, and implementing large-scale institutional change. By means of laws and regulations, the state specifies the fundamental rules of competition and cooperation in devising the system of property rights. As a revenue maximizer, the state has an incentive to lower transaction costs in order to stimulate the productive output of society and by this means increase tax revenue. But, as North emphasizes, states seldom get it right, and more commonly institute and maintain arrangements that are inefficient.

North was the first new institutional economist to highlight the importance of informal norms, customs and conventions, arguing that informal and formal constraints operate together in providing an underlying structure for economic activity. In his framework, institutions are defined as humanly constructed constraints, the formal and informal elements that structure incentives for economic and political actors. "Formal rules are an important part of the institutional framework but only a part. To work effectively they must be complemented by informal constraints (conventions, norms of behavior) that supplement them and reduce enforcement costs" (North 1993: 20). He acknowledges, however, that economics currently understands "very little about how informal norms evolve" and how they combine and interact with formal rules to structure incentives. "What is it about informal constraints that gives them such a pervasive influence upon the long-run character of economies? What is the relationship between formal and informal constraints?" (North 1991: 111). Williamson (2000) also recognizes that economists encounter difficulty in understanding the powerful effect of networks and norms on economic action: "We are still very ignorant about institutions…..North does not have an answer…nor do I" (2000: 596).

Informal networks and norms, operating in combination and interaction with the formal rules of the game, can both limit and facilitate economic performance. They can give rise to inefficient allocation of resources when interest groups collude to secure resources from government, resulting in structural rigidities and stagnation (Olson 1982). They can also promote the growth of a new industry by providing a framework for trust and collective action (McGuire et al. 1993). Economic sociology has made progress in accounting for how informal and formal institutional elements combine and interact in an institutional environment (Nee 2004). Its contribution to a cross-disciplinary understanding of institutional change is to focus analytic attention on explaining why networks and norms can have powerful effects in shaping economic and social behavior. Networks and the informal norms can play a decisive role in rendering formal rules ineffectual or effectual Nee and Ingram (1998). If formal rules are in alignment with the informal norms, identity and interests of actors in networks, then monitoring and enforcement of formal rules will be to a large extent assumed by social networks, giving rise to transaction cost economizing. On the other hand, if the formal rules are aligned against the identity and perceived interests of members of close-knit groups, oppositional norms are likely to emerge to counter the formal rules.[1]

Although North's theory asserts that organizations are important players in institutional change, there is surprisingly little said about organizations per se. The main references are to Coase's (1937) transaction cost theory of the firm, and to the extension of this theory by Williamson (1975). Otherwise, North assumes organizations behave like rational actors in their response to market incentives, adapting readily and unproblematically to changing relative prices. This may provide an accurate model of organizational actors in a stable institutional environment where existing rules and procedures provide a reliable guideline for organizational response, and where the corporate governance is structured so that management is accountable for the firm's performance. But it provides at best a faulty model in the context of a rapidly changing institutional environment in which the existing repertoire of rules and procedures no longer works to provide a helpful roadmap for effective organizational action. Under such circumstances, the customary roadmaps of appropriate organizational responses do not yield their expected utility because established rules and procedures no longer work as ready guidelines for effective action. Indeed, I argue that under conditions of transformative change, the old rules and procedures frequently become, instead, sources

---

[1] These propositions explaining the nature of the relationship between informal and formal norms are grounded in case studies of close-knit groups in a variety of organizational and institutional settings (Homans 1950; Blau 1964; Shibutani 1978; Ellickson 1990).

of oppositional norms, which in turn reinforces organizational inertia to the extent they lock organizational actors into routines that are at odds with the path of institutional change. The naive view of efficient organizational adaptation to change in relative price in North's theory is, I maintain, a serious limitation.

Organizational analysts proffer a theory of structural inertia of organizations, which specifies just why they are unable to adapt quickly and effectively to changes in their institutional environment. Learning and adapting by organizations is relatively slow due to structural inertia, defined as a slower speed of adaptation than the rate of change in the institutional environment (Hannan and Freeman 1984). Organizations are complex entities that require resources to build and maintain, which are costs sunk in the organizational structure. Not only is the cost of building an organization nontrivial, but organizations require resources just to maintain and reproduce their structure, apart from performing collective action. Organizations that manage to survive competitive pressures in their niche have invested considerable resources to ensure reliability of performance, secured by maintaining reliability in compliance to rules and procedures. Moreover, organizations gain legitimacy by producing internally consistent accounts showing that appropriate rules and procedures are in place to produce rational allocations of resources and appropriate organizational action. Thus organizations possess relatively fixed repertoires of rules and procedures. Resistance to change is a "by-product of the ability to reproduce a structure with high fidelity: high levels of reproducibility of structure imply strong inertial pressures" (Hannan and Freeman 1989: 77). Because selection pressures favor organizations with a high level of inertia, successful organizations tend to be those that carry with them the strongest inertial forces.

As organizations age, they face stronger inertial pressures. Hannan and Freeman (1989) observe that "nothing legitimates both individual organizations and forms more than longevity" (81). Older organizations develop strong attachments to established rules and routines and dense network ties to centers of power. Their capacity for reliable and accountable action ironically slows their ability to adapt to environmental threats and opportunities. In contrast, new organizations and new organizational forms have lower levels of reproducibility. This gives rise to the "liability-of-newness," defined as a greater risk of failure faced by new organizations Stinchcombe's (1965). However, new organizations and organizational forms are more able to adapt quickly and effectively to changes in their environment. By extension, they are more able to champion new institutional arrangements because long-standing routines and rules encumber them less (Ingram 1998).

The claim that structural inertia renders the existing stock of organizations slow to adapt to change in their environment poses a challenge to North's theory of institutional change. This challenge, moreover, cannot be readily solved from within the theoretical logic of transaction cost economics which assumes that firms adapt efficiently to changes in relative prices, though, as North maintains, the state as an actor often institutes inefficient property rights and formal rules. However, the structural inertia hypothesis of is consistent with and complementary to my argument that oppositional norms rooted in close-knit networks pose an incorrigible challenge to state-initiated institutional change because they significantly reinforce organizational inertia. Rapid changes in formal rules threaten established repertoires of organizational routines and identities, which gives rise to both manifest and latent opposition to the new rules of the game. Opposition norms often evolve out of the preexisting organizational rules and practices, which in the past structured incentives to benefit powerful networks in the firm.

Both the opposition norm and structural inertia hypotheses specify social mechanisms that claim broad explanatory power in understanding the organizational constraints on state-initiated institutional change. They suggest that new organizations and organizational forms are more capable of robust action in championing institutional change than old organizational forms, which are more vulnerable to lock-in and path dependence stemming from oppositional networks and norms. Hence new organizations and organizational forms adapt more readily to rapid changes in the institutional environment.

In the next sections, I will examine institutional change in China, first through the lens of North's theory of institutional change, and then from the vantage point of insights from economic sociology. Changing relative prices stemming from advances in technology, especially military technology, in the advanced capitalist countries compelled communist reformers in state socialist economies to "sleep with the enemy" and launch large-scale institutional change to remake their economic institutions by expanding the role of markets (Nee and Lian 1994). These changes were initiated by the state as a means to maximize state revenues through improved economic performance, in large measure in response to a perceived intensification of inter-state competition with rival states at a time when state socialist economies experienced declining economic performance due to inefficiencies in central planning. In China, as the enormous pool of cheap unskilled and skilled labor became available to international capital and as investments and global markets opened up to Chinese entrepreneurs and managers, the state initiated a series of innovations aimed at instituting the foundations of state capitalism. In the next section, I summarily describe very cursorily the decline of redistribution as an institutional form and the emergence of a market economy in China in order to document the rapidity of large parameter shifts in the institutional environment.

DECLINE OF SOCIALIST REDISTRIBUTION AND EMERGENCE OF MARKETS

In the 1980s, the Chinese economy shifted decisively away from nonmarket mechanisms for coordinating economic activity. The departure from reliance on central planning entailed a broad-based dissolution of the redistributive mechanisms controlled by the central government. First, a dramatic decline took place in the proportion of factor resources that were subject to allocation by central planning. This declined from 70 per cent in 1980 to 14 per cent in 1991. With respect to the distribution of manufactured goods, the categories of products subject to mandatory distribution through nonmarket channels decreased from 120 in 1980 to 50 in 1988 to make up only 16.2 per cent of the total value of industrial output. By 1991, the number of categories dropped to only 21. Parallel to this, the number of commodities distributed by the state supply bureaucracy declined from 256 in 1980 to only 19 by 1989. These massive shifts away from central planning led to significant declines in the redistributive role of the central state. Although the state continued to set the prices for key agricultural and industrial products, by the early 1990s state regulation was no longer the dominant mechanism determining the prices of goods and services in the Chinese economy.

Rapid growth and diversification of domestic market institutions accompanied China's opening to the global market economy. The number of marketplaces more than doubled from 1978 (33,302) to 1991 (74,675). The volume of transactions in these markets increased at an even more rapid rate (over 20 times) from an initial small base in rural free markets. By the 1990s, there was a wide variety of market arrangements, including many types of commodity markets, labor markets, realty markets, financial markets, and lending institutions. Regional and provincial market centers that flourished prior to the revolution quickly reemerged. In the southeastern provinces of Guangdong and Fujian, for example, dense multiplex regional marketing networks linked to the economies of Hong Kong and Taiwan created the central places of a new capitalist economy. Foreign direct investments increased rapidly for more than two decades, with overseas Chinese, Taiwan, Japan and the United States providing the largest sources of foreign capital. As multinational corporations moved manufacturing to China to take advantage of its huge supply of cheap unskilled and skilled labor, China emerged as the fastest growing economy in the world. Since 1980, China's GDP grew at an average annual rate of 8.6%. The sustained two-decade surge in China's exports was accompanied by an unexpectedly swift movement up the product chain in the goods manufactured in China, from cheap low-technology to high quality high technology products.

The resulting growth and diversification of a market economy in China have implications for the behavior of political and economic actors. The number and variety of markets and the dramatic increase in the sheer volume of market transactions comprise a significant source of discontinuous change in the institutional environment, especially for state-owned firms. These firms can no longer depend on the state for their inputs and for the distribution of their products. Instead they find subcontractors outside of the state-managed economy, or go directly to wholesale markets and even international markets in competitive bids to gain price advantages and market share. Also, with the emergence of regional marketing networks, competition is no longer limited to local markets, but is regional and global in scope. In short, due to rapid parameter shifts driven by the transition to a market economy, the old rules and procedures of state-owned enterprises do not provide useful roadmaps for effective responses to competitive pressures. Yet because the old organizational rules and routines are enmeshed with the interests and identity of individuals in powerful networks entrenched inside the state-owned firms, organizational inertia is reinforced, resulting in structural rigidities that lock these firms into inefficient economic performance.

THE INSTITUTIONAL FOUNDATION OF STATE CAPITALISM

Changing relative prices, driven by an expanding market economy, motivated the state to redefine its relationship to state-owned firms (Naughton 1995; Steinfeld 1998; Keister 2000). North's theory finds support in the sequence of state-crafted institutional innovations directed at motivating improvements in these firms' economic performance. New institutional arrangements diffused quickly to provide a variety of hybrid governance structures for local government-owned industrial firms (Oi 1995; Nee and Cao 1999). They helped to improve the economic performance for township and village enterprises by specifying property rights over rural industry under local government ownership (Walder 1995). New profit-sharing arrangements opened the way for informal forms of privatization based in local networks (Nee and Su 1996).

However, state-crafted institutional innovations that proved favorable to township and village enterprises could not be readily extended to reform large state-owned enterprises, continued to operate at a loss and hence to drain state resources . In an attempt to address the problem, in the mid-1990s the Chinese government initiated an ambitious series of institutional innovations aimed at reforming the governance structure of state-owned enterprises. The main legislation was the Company Law, which was enacted by the Fifth Session of the Standing Committee of the Eighth National People's Congress of China on December 29, 1993 and promulgated on the same day. Outlined in eleven chapters and specified in 230 articles, this complex state-crafted institutional innovation provided the formal rules of a "modern enterprise system" (*xiandai qiye zhidu*) to enable state-owned enterprises to adapt to a rapidly expanding market economy by means of conversion to profit-maximizing capitalist firms.

In drafting this legislation, reform economists in Beijing borrowed extensively from the legal framework of corporate governance and shareholder rights in the West, principally corporate and securities laws of the United States and Australia (Wang and Tomasic 1994). The Company Law elaborates and specifies the formal rules specifying the corporate governance to be adopted by state-owned enterprises as they reorganized themselves into for-profit public corporations. The Law lays out the rules and procedures by which state-owned enterprises change their legal status to that of a "limited-liability company" (*youxian zeren gongsi*) or a "joint-stock company" (*gufen youxian gongsi*); foreign and joint-venture firms are regulated by different laws and regulations. The

Company Law specifies the rights of shareholders and creditors. It confers to the joint-stock company the right to be listed on the stock exchange, and presumably partially privatize through issuing securities.

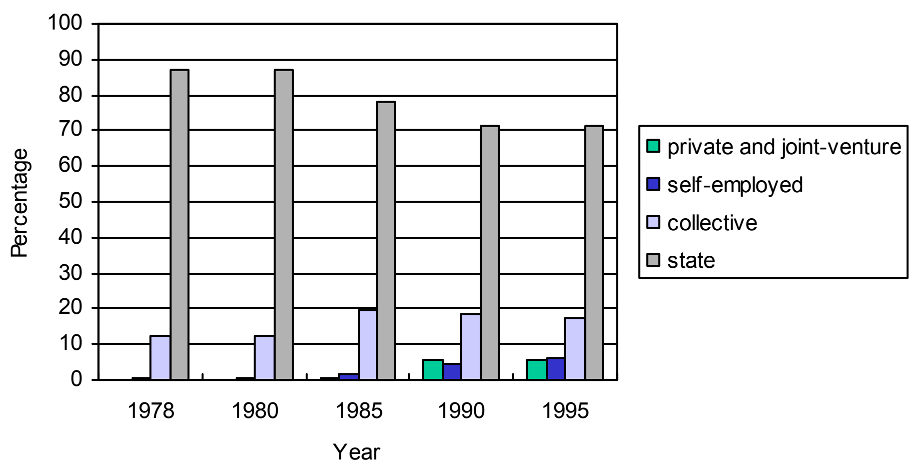
As in the West, the firm has the rights of a legal person in regard to its property, where liability is limited to the amount of capital contributed by each shareholder in a limited-liability company and the amount of shares held by a shareholder in the joint-stock company. The new status of the firm as a legal person represents significant progress over earlier reform laws in clarifying the structure of property rights for state-owned enterprises (Wang and Tomasic 1994). Previously, the enterprise's property rights were limited to possessing, utilizing and disposing of property which the state authorized it to operate and manage, leaving no clear legal separation between the company's property rights and those of the state. The Company Law instead provides a legal basis for the partitioning of rights of shareholders—principally the state—and the firm. Reflecting the partitioning of rights, the Company Law stipulates that the enterprise is legally responsible for its own profits and losses and the state may not intervene in the management of the firm. Furthermore, it limits the state to exercising macro-economic adjustments and controls. As long as the company conducts its business within the framework of the law and government macro-economic policy, it has the right to make its own decisions in accordance with market conditions. The Company Law stipulates that the firm must conform to the separation of authority between the manager and board of directors. And it must lawfully safeguard the rights of shareholders.

The broad outlines of the Company Law are laid out in its General Provisions. To my mind, the defining feature of state capitalism in China is specified by article 17, which recognizes the right of the Communist Party to carry out its activities in the enterprise. This article cements the political orientation of the state as integral to its economic institutions. In the main body of the Law there are 211 articles detailing every aspect of corporate governance. These include careful specification of how limited-liability and joint-stock companies are to be set up with respect to the number of shareholders, their rights, the purpose of shareholders' meetings, their frequency, the disposition of start-up capital, the company's name and organizational structure, and the company's physical plant. The Company Law requires firms to have a board of directors, and specifies through its articles the composition, selection procedures, organization, term of office, responsibilities and rights of this board. As in western corporate governance, the chairman of the board is the legal representative of the firm. The board of directors is charged with the responsibility for appointing and dismissing the firm's management.

In keeping with its intent to impose formal constraints on the state's involvement in the firm, the Company Law states that government employees are disqualified from serving as directors or managers of a company. The Law also clarifies the limits of the authority of directors and managers. It definitively spells out legal restrictions against patrimonial uses of the company's resources and funds. Furthermore, it explicitly forbids directors and managers to engage in business activity in competition with their company, or to disclose company secrets, and specifies their liability to compensate the firm for damages if they violate the law and regulations of the state.

Viewed from the lens of North's theory of institutional change, the promulgation of the Company Law appears to follow his story line. Changing relative prices, both preceding and accompanying deepening shifts to reliance on markets and the decline in central planning, forced the hand of the central state. As a revenue maximizer, the state has a powerful interest in devising a new structure of property rights that can promote needed improvements in the economic performance of its main assets, state-owned enterprises. Figure 1 shows that through the course of economic reform and the enactment of the Company Law, the state's revenues overwhelmingly derived from state-owned enterprises, even though the percentage declined from nearly 90 percent at the start of economic reform to a little over 70 percent by 1995. Hence it remained very much in the state's interest to devise a structure of property rights that could turn the loss-making state-owned enterprises into profitable businesses.

Figure 1. The structure of government revenue by ow nership.*



The state's strategy was to convert state-owned enterprises into profit-maximizing capitalist firms by instituting Western corporate governance structures in China. The attraction of this to reformers is obvious: it provided guidelines legitimated by the success of public corporations in advanced capitalist economies of the West, which conveniently allows the state to maintain formal ownership of state-owned enterprises, while specifying corporate governance that reformers believed would enable managers of the restructured state-owned firms to compete with foreign firms, capitalist hybrids (joint-venture firms) and private enterprise in the emerging market economy.

By the mid-1990s, the institutional foundation of state capitalism was in place in China. As North's theory would predict, in a global context of changing relative prices, the revenue maximizing interests of China's rulers, competition with rivals, and the lobbying activity of managers of state-owned enterprises all contribute to explaining the institutional changes embodied in the enactment of the Company Law. But difficulties with North's theory begin to emerge when one examines the state's enforcement of the Company Law and the response of enterprise managers. Here is where organizational ecology has much to contribute to explaining the organizational dynamics of institutional change—specifically, first, organizational ecology's argument that structural inertia makes organizations slow to adjust to changes in their institutional environment; and second, study of the relationship between informal and formal institutional constraints, pointing to oppositional networks and norms to the formal rules.

In Shanghai, China's largest industrial and commercial city, shortly after the implementation of the Company Law, interviews with managers of state-owned enterprises show that they were aware of the Company Law, but uncertain about how it would concretely effect their firm (Guthrie 1999). Firms that applied to the municipal agency charged with overseeing the implementation of the Company Law were casually granted permission to change their legal status into a limited-liability or joint-stock company without clear interpretation of the rules to provide practical guidelines for conversion of state-owned enterprises into public corporations. Management often operated within the same *de facto* rules and procedures as those that were in place when they were state-owned enterprises (Li 1998; Ye and Liang 1999). The firm's party committee frequently continued to appoint the heads of companies and to intervene in the company's management. Managers often appointed the members of the board of directors, rather than the board of directors appointing the manager. Moreover, the company's party secretary commonly served as the chairman of the board. Initially at least, the board of directors had little authority over the firm's management (Li 1998; Ye and Liang 1999). Though the Law stipulated that the same person cannot hold simultaneously the positions of chairman of the board and CEO, firms were frequently in violation of this rule. In 1999, 18 percent of firms listed on the Shanghai Stock Exchange showed that the CEO and chairman of the board was the same person (Opper, Wang and Hu 2002). In short, despite the formal rules specified by the Company Law, the old repertoire of organizational rules and procedures remained in place, giving rise to decoupling between the rules of corporate governance specified in the Company Law and the actual organizational routines and practices of firm.

Court records reveal very few cases litigating the Company Law, and these involved prosecutions of traditional economic crimes such as bribery, embezzlement and other forms of corruption. Despite the weak and sporadic nature of state enforcement, however, the interest of managers in gaining legitimacy accounted for increased formal compliance with the Company Law. Guthrie's (1999) analysis indicates that voluntary formal compliance appeared in firms he surveyed in Shanghai because managers actively seek the mantel of legitimacy associated with being viewed as a modern Western-style corporation. As DiMaggio and Powell (1983) persuasively argue, organizations come to comply with rules institutionalized and legitimated by central states because they gain better access to resources by being perceived as legitimate; further, organizations respond to uncertainty by mimicking or copying legitimatized procedures and models; and lastly, professionals experience normative pressures to accept and act on models of appropriate behavior. These studies of state-owned firms in Shanghai appear to support these hypotheses.

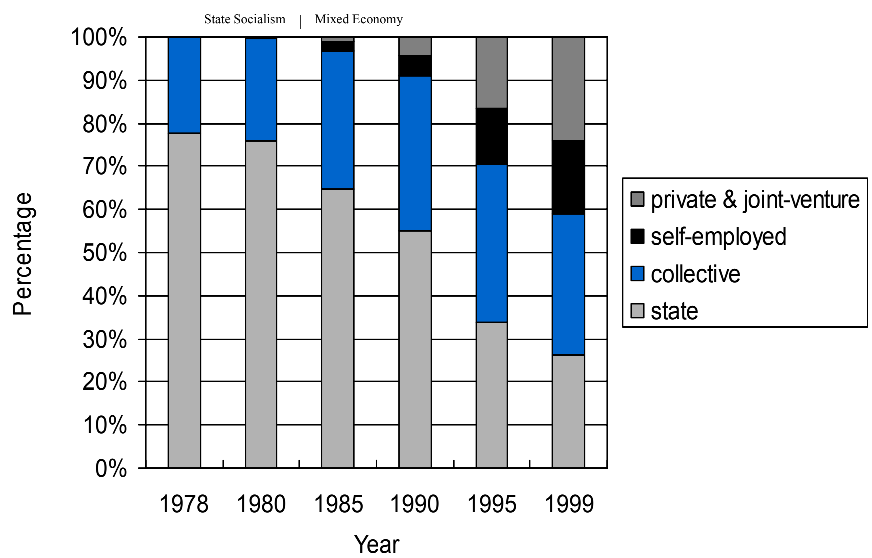
By 2000, a study of the corporate governance structure of 257 companies listed on the Shanghai Stock Exchange confirms that the formal rules and procedures specified by the Company Law in fact shaped corporate governance and decision making (Opper, Wong and Hu 2001). In compliance with the Law, shareholders' meetings were held annually and substantive decisions were made at the meetings. Boards of directors were organizationally important—deciding on the selection and dismissal of managers, setting their remuneration, calling board and shareholder meetings and setting their agendas, formulating the company's strategic plan, organizing training for members of the board and management, electing and dismissing the chairman of the board and its secretary, and making a wide range of decisions regarding strategic investments by the firm. Overall, the survey shows that formally the board of directors has the widest range of decision-making power, followed by the manager, the shareholders' meeting, the board of supervisors, and lastly the communist party branch.

Notwithstanding the formal changes in decision-making, the informal decision-making power embedded in party-controlled networks perpetuates the organizational culture of the state-owned enterprise. This is especially the case in companies where the chairman of the board is the same person as the party secretary. Meyer and Rowan (1977) argue that such decoupling between formal rules as myths and rituals and the actual organizational practices enables the firm to conform to expectations emanating from the institutional environment while allowing actors in the firm to pursue practical objectives. The same survey of 257 listed companies confirms that the communist party continues to intervene in the management of the firm through informal governance structures that operate in the shadows of the formal rules and procedures (Opper, Wong and Hu 2002). In sum, despite impressive evidence of formal compliance to the formal rules and procedures of corporate governance specified by the Company Law, opposition norms rooted in the culture of party-controlled networks in the firm continued to be manifest in a wide range of organizational practices.

A different type of oppositional norm is manifest in widespread asset stripping in state-owned companies following the promulgation of the Company Law (Li 1998). Prior to the enactment of the Law, state agencies monitored the financial accounts of state-owned enterprises; by eliminating monitoring, the new structure of property rights opened the door to asset stripping. Widespread asset-stripping can take place only if management tacitly cooperates and even profits from such activity, through lax monitoring of the informal economy that operates in the shadows of the formal economy of the firm. A common practice in firms is for entrepreneurs to organize a work group of employees and bid for contracts on the open market. Although they may work on the project during off-hours, they nonetheless use the firm's equipment and plants without compensating the firm for the costs of depreciation of physical capital. Once incorporated into a firm's organizational culture, the informal economy becomes a source of oppositional norms to management's effort to utilize the firm's human and physical capital to pursue profit-making that accrues to the firm rather than to individual entrepreneurs and members of work groups. Moreover, it is not uncommon for management to join close-knit networks comprising the firm's informal economy. A more serious form of asset stripping stems from outright illegal sale of physical capital and assets, which can result in costly losses for state-owned companies.

Oppositional norms are also evident in welfare-maximizing expenditures whereby management lavishly allocates the firm's investment capital to build new housing for employees and to provide other nonwage benefits. Such expenditures are not based on productivity gains, but are driven by the clientelist politics of the party organization, a long-standing feature of the organizational culture of state-owned enterprises (Walder 1986). Party leaders use their redistributive power to build a coterie of loyal employees who they can turn to for support, especially during campaigns led by the party organization in the firm. They seek to promote welfare-maximizing expenditures aimed at augmenting nonwage benefits that can placate workers discontent over wages falling relative to private, foreign and joint-venture firms. One common welfare-maximizing practice is to defer the lay-off of workers even when the company continues to sustain losses. The norm of lifetime employment becomes an oppositional norm in the context of the company's formal goals of profit-maximization. Similarly, the long-standing practice of late arrival to work and early departures, long lunch breaks and rest periods, also becomes a source of oppositional norms in state-owned companies. By contrast, the work rules of new private firms, foreign branch firms, and even joint-venture firms conform to the conventions of capitalist firms elsewhere.

Figure 2. The structure of industrial output value.*

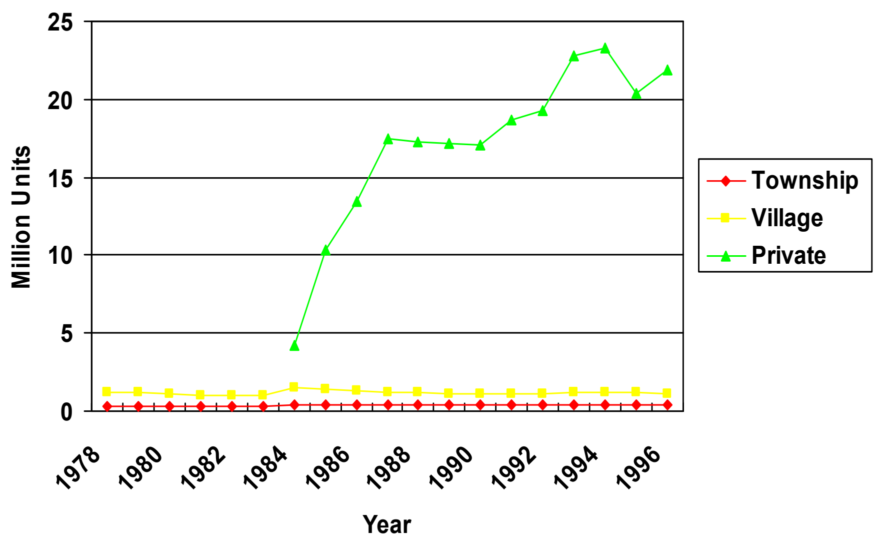


*Source: State Statistical Bureau (http://www.stats.gov.cn/sjjw/ndsj/zgnj/2000/M03c.htm). Economic types of enterprises and their output values were adjusted for comparison among historical years after 1998.

Even after the restructuring of property rights and the formal adoption of corporate governance structures that came with the implementation of the Company Law in the mid 1990s, the share of the total industrial output of private and joint-venture firms and self-employed entrepreneurs continued to displace that of state-owned enterprises, as Figure 2 shows. By 1999, the state-owned companies account for only slightly over 25 percent of the value of industrial output, declining from almost 80 percent in 1978 at the start of China's economic reforms. The pace of decline in the share of industrial output accelerates as the broader institutional environment shifts away from a centrally planned economy to a mixed market economy in the late 1980s.

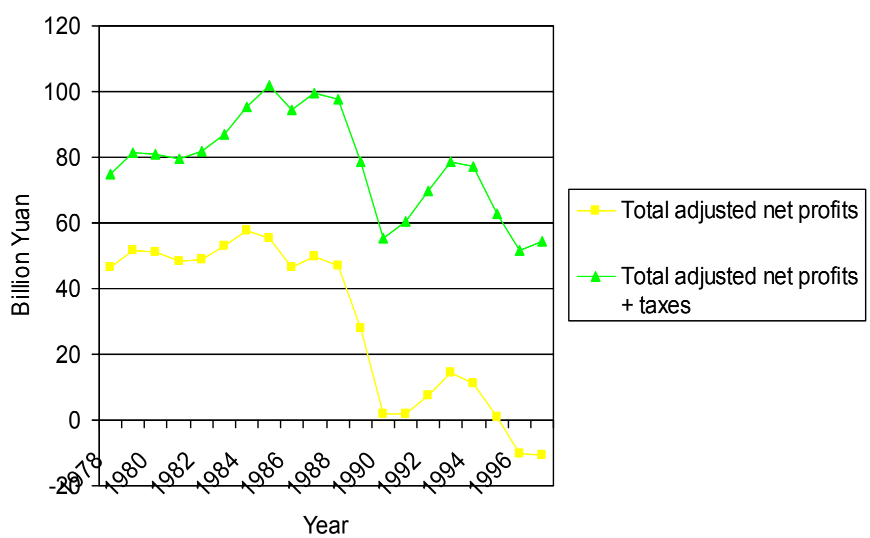
New organizations and organizational forms adapted more effectively and quickly to changes in the institutional environment stemming from the shift to market coordination than the state-owned firms. This can be inferred from the rapid growth in the number of new private firms in the rural industrial sector alone, shown in Figure 3. If new organizations and organizational forms more readily endorse the new rules and procedures, then they will be the first to display organizational behavior that most fully reflects private property rights. That the old organizational form of state-owned enterprises is slower to adapt to the new rules of a market economy, despite efforts to change the structure of property rights by mimicking western corporate governance structures, can be inferred from the superior performance of new organizations and organizational forms reported in Figure 2. It is also reflected in the exponential growth in the number of private industrial firms in the mid-1980s, although as organizational ecology predicts, the growth levels off when density intensifies competition by the late 1980s (Hannan and Freeman 1989).

Figure 3. Property forms in rural industry.*



*Source: State Statistical Bureau (1991: 377; 1997: 399).

Figure 4. Economic performance of state enterprises.*



*Source: State Statistical Bureau (1998: 461); All numbers are adjusted by General Retail Price Index (1999: 294).

The declining economic performance of state-owned enterprises is unmistakably clear when we examine the net profits and net profits plus tax revenue to the state for state-owned enterprises (Figure 4). Decline in profits and tax revenues is especially steep during the recession of the late 1980s; economic recovery is evident in the early 1990s, but around the time of the enactment of the Company Law, profits and taxes fall off again. Data on the economic returns to investments in state-owned companies (Figure 5) also shows a continuous decline in economic performance, beginning at the time of the start of rapid change in the institutional environment. This is consistent with the view that state-owned companies have persistent problems of organizational inertia. Even if not all state-owned firms were corporatized, there should have been signs of improving economic performance as more of them adopted modern corporate governance. The data from both figures shows through much of the 1990s there was no discernible positive effect of change in the structure of property rights and corporate governance on the performance of state-owned companies. In other words, whether governed by modern corporate structures or not, older industrial firms in the aggregate were unable to respond effectively to the changes in their institutional environment. The economic performance of township and village enterprises also declined (Figure 6). There is evidence that this begins to level off in the 1990s, perhaps due to extensive informal privatization in the rural industrial sector (Nee and Su 1996; Peng 2001); nonetheless, the data shows that the rural industrial sector is experiencing stagnation in productivity gains.

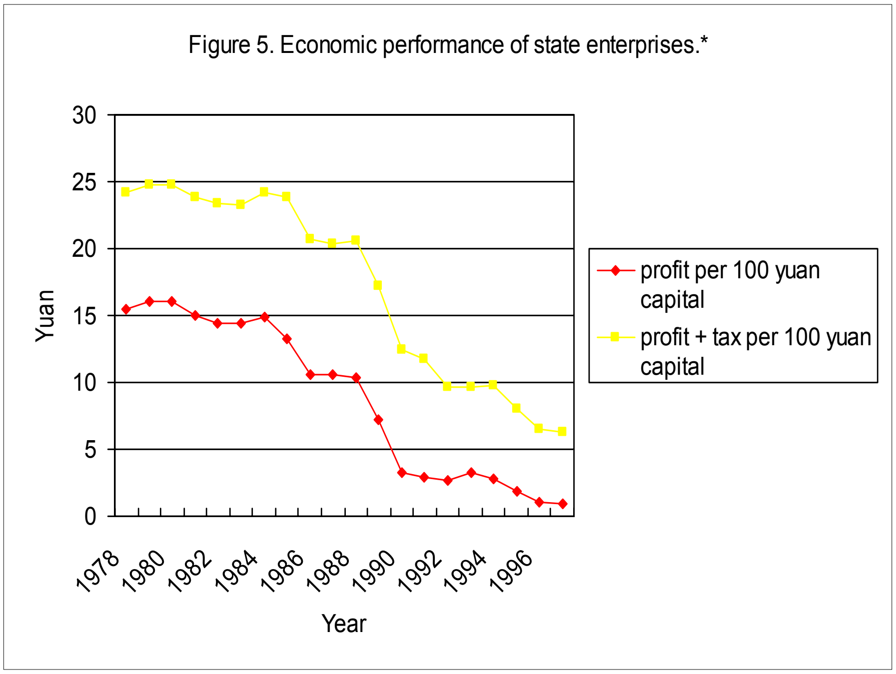


Figure 5. Economic performance of state enterprises.*

*Sourse: State Statistical Bureau (1991 -- 1998).

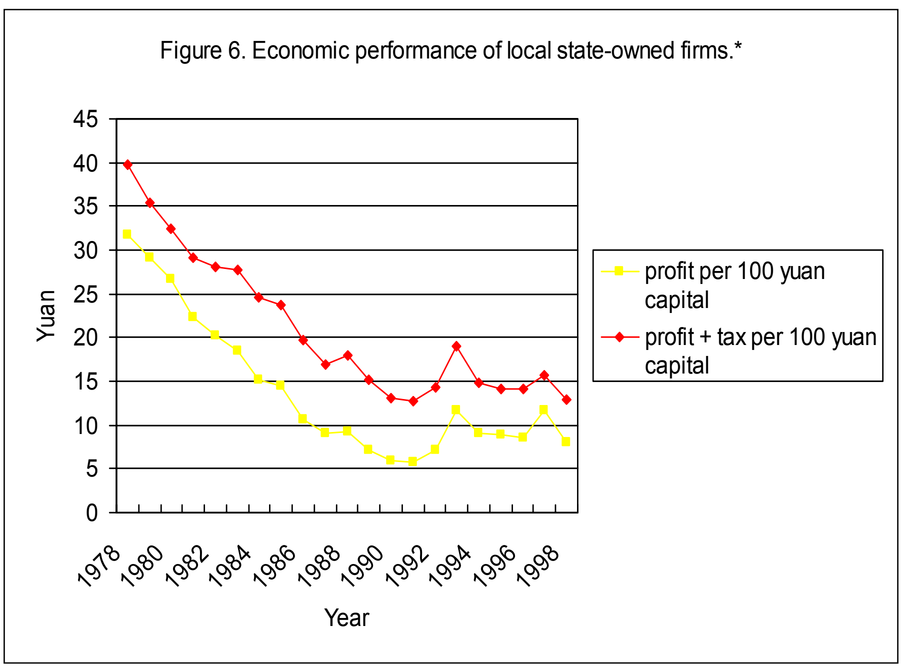


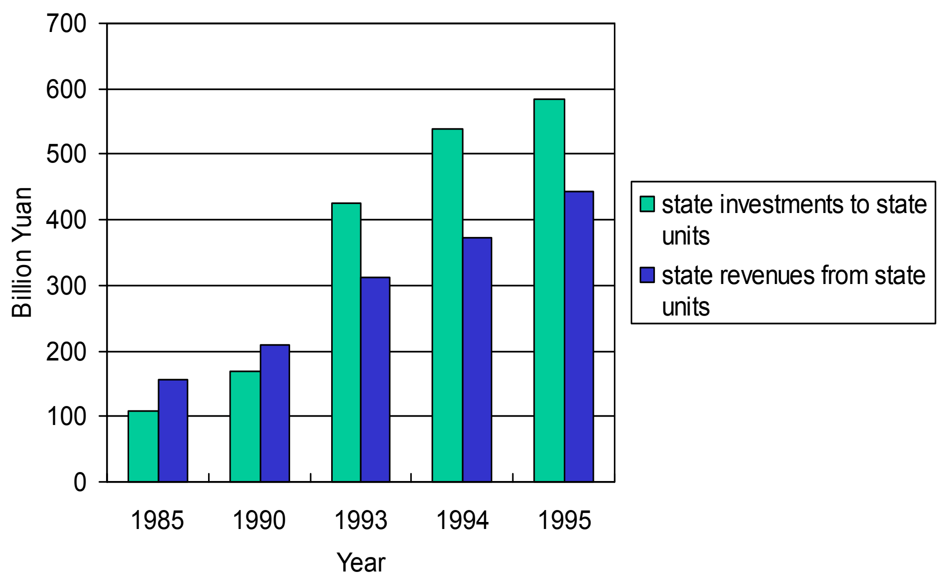
Figure 6. Economic performance of local state-owned firms.*

*Source: State Statistical Bureau (1991 -- 1999).

Finally, Figure 7 reveals a trend that suggests why state-crafted institutional innovations aimed at building state capitalism in China might not result in a stable institutional framework for capitalism in China. It shows a dramatic reversal in returns on investment capital, which were already low during the pre-reform period of extensive economic growth, but which grow seriously in deficit by 1993 and the years immediately following the enactment of the Company Law. This trend is consistent with the problems that were experienced by East Asian capitalist economies in confronting the limits of extensive economic growth. Compounding the problem, state-owned banks in China are lending to state-owned companies investment capital, likely to become problem loans in light of their continuing poor economic performance.

The paradox of China's rise as a major manufacturing power in the global capitalist economy is that it is both the fastest growing economy in the world and also among the most inefficient. Symptomatic of the problem is the sorry state of China's banking system, which has a bad loan ratio of 50%, arguably the highest of the major economies in the world. Bank loans make up 98% of the total financing of Chinese firms. As the economist Weijian Shan observes: "Standard & Poor's estimates that it will cost some $518 billion, or more than 40% of China's GDP, to clean up China's banking system. These costs plus the equity write-off of those companies that will go bankrupt without continued funding from banks translate into years of negative growth. China's growth therefore can be regarded as being borrowed at a very high cost—which will need to be repaid sooner or later" (*Wall Street Journal*, October 7, 2003). This analysis is consistent with my view that the 1990 institutional innovations to establish the institutional framework of state capitalism in China are unlikely to succeed, and will be followed by new reform measures aimed at building a capitalist economy not dissimilar to the pattern established elsewhere in East Asia. Indeed, in 2002, the Communist Party Congress instituted new rules to privatize state-owned firms, pave the way for loss-making firms to declare bankruptcy, and clean up bad loans held by banks.

Figure 7. Investments to and revenues from state units: 1985 -- 1995.*



*Source: State Statistical Bureau (1998: 272; 1996: 143). Here state investment includes capitals from both state budgets and extra-budget funds.

CONCLUSION

The structure of property rights specified by the Company Law formally partitioned rights in a manner not dissimilar to corporate governance in advanced capitalist economies. It is reasonable to assume that if property rights were the main culprit in a persistent trend of declining firm performance, then as more and more firms adopted modern corporate governance structures, there should have been a discernible reversal in the trend of declining economic performance of state-owned companies by the late 1990s. Clearly this has not occurred. Thus a property rights interpretation does not by itself explain the observed trends. We need also to consider the social mechanisms explaining structural inertia in organizational responses and oppositional norms embedded in longstanding networks in the firm, as discussed earlier. Furthermore, property rights are themselves fundamentally a bundle of informal and formal rules governing the use of resources (Demsetz 1967). Despite formal changes embodied in the Company Law, informal rules reflecting path dependent norms and entrenched practices from the earlier era of state-owned enterprises can and do operate as oppositional norms, which combine to cause organizational inertia in these older forms. Hence a property rights interpretation is not incompatible with arguments that emphasize the importance of social mechanisms in explaining the organizational dynamics of large-scale institutional change we have witnessed in the departures from central planning in post-socialist societies.

North's account of institutional change is the centerpiece of the New Institutional Economics. It won him the Nobel Prize in Economics, and interest in his theory has diffused widely in political science, understandably because North's theory has revitalized interest in classical themes of political economy. His theory achieves parsimony and generality by integrating a neoclassical theory of the state with standard marginalist theory in economics. Its strength is its robustness in explaining the role of the state in making institutional innovations and the incentives stemming from changing relative prices in motivating both organizational actors and the state. Its weaknesses stem from its attempts to explain the organizational dynamics of institutional change solely by reference to derivations from standard economic theory. Because the identity and network-based interests of members of close-knit groups matter, oppositional norms rooted in path dependent practices of older firms can be expected to undermine and severely constrain their ability to respond effectively to rapid parameter shifts in the institutional environment. Structural inertia stems from success in reproducing procedures and routines with high fidelity, which in the past enhanced firms' (and states') ability to survive competitive pressure; thus North's theory is far too optimistic about the adaptive capacity of the existing stock of organizations. In contrast, economic sociology emphasizes not the existing stock of old organizations as players in large-scale institutional change, but the role of new organizations and new organizational forms.

REFERENCES

Blau, Peter. 1955. *The Dynamics of Bureaucracy*. 2d ed. Chicago: University of Chicago Press.

Chandler, Alfred D., Jr. 1977. *The Visible Hand: The Managerial Revolution in American Business.* Cambridge, MA: Harvard University Press.

Coase, Ronald. 1937. "The Nature of the Firm." *Economica*, 4:386-405.

Demsetz, Harold. 1967. "Toward a Theory of Property Rights." *American Economic Review* 57:347-59.

DiMaggio, Paul J., and Walter W. Powell. 1983. "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields." *American Sociological Review* 48: 147-60.

Ellickson, Robert. 1991. *Order without Law.* Cambridge, MA: Harvard University Press.

Fligstein, Neil. 1990. *The Transformation of Corporate Control.* Cambridge, MA: Harvard University Press.

Granovetter, Mark. 1985. "Economic Action and Social Structure: The Problem of Embeddedness." *American Journal of Sociology* 91:481-510.

Guthrie, Doug. 1999. *Dragon in a Three-Piece Suit: The Emergence of Capitalism in China.* Princeton: Princeton University Press.

Hannan, Michael T. and John Freeman. 1984. "Structural Inertia and Organizational Change." *American Sociological Review* 49: 149-164.

_____. 1989. *Organizational Ecology*. Cambridge, MA: Harvard University Press.

Homans, George C. 1950. *The Human Group.* New York: Harcourt Brace Jovanovich.

Ingram, Paul. 1998. "Changing the Rules: Interests, Organizations, and Institutional Change in the U.S. Hospitality Industry." Pp. 258-276 in in *The New Institutionalism in Sociology*, edited by Mary C. Brinton and Victor Nee. New York: Russell Sage Foundation.

Keister, Lisa. 2000. *Chinese Business Groups: The Structure and Impact of Interfirm Relations during Economic Development.* Oxford: Oxford University Press.

Li, Zinai. Ed. 1998. China's Dilemmas in the Turn of Century: Topics on the Public Policies of the New Administration of the State Council. (*shiji zhijiao de gongjian: xin yijie zhongguo zhengfu zhengce zhuanti jiangzuo*) Beijing: China Fiscal Economic Press.

McGuire, Patrick, Mark Granovetter, and Michael Schwartz. 1993. "Thomas Edison and the Social Construction of the Early Electricity Industry in America." Pp. 213-48 in *Explorations in Economic Sociology*, edited by Richard Swedberg. New York: Russell Sage Foundation.

McMillan, John and Barry Naughton, eds. 1996. *Reforming Asian Economies: The Growth of Market Institutions*. Ann Arbor: University of Michigan Press.

Meyer, John and Brian Rowan. 1977. "Institutionalized Organizations: Formal Structure as Myth and Ceremony." *American Journal of Sociology* 83: 340-63.

Naughton, Barry. 1995. *Growing out of the Plan: Chinese Economic Reform 1978-1993.* Cambridge: Cambridge University Press.

Nee, Victor. 2004. "A New Institutional Approach in Economic Sociology." In *The Handbook of Economic Sociology* (2nd edition), edited by Neil Smelser and Richard Swedberg. New York and Princeton: Russell Sage Foundation and Princeton University Press.s

Nee, Victor, and Peng Lian. 1994. “Sleeping with the Enemy: A Dynamic Model of Declining Political Commitment in State Socialism.” *Theory and Society* 23: 253-296.

Nee, Victor, and Sijin Su. 1996. “Institutions, Social Ties and Commitment in China’s Corporatist Transformation.” Pp. 111-134 in *Reforming Asian Economies: The Growth of Market Institutions*, edited by John McMillan and Barry Naughton (Ann Arbor: University of Michigan Press.

Nee, Victor, and Paul Ingram. 1998. “Embeddedness and Beyond: Institutions, Exchange, and Social Structure.” Pp. 19-45 in *The New Institutionalism in Sociology*, edited by Mary C. Brinton and Victor Nee. New York: Russell Sage Foundation.

Nee, Victor, and Yang Cao. 1999. “Path Dependent Societal Transformations.” *Theory and Society* 28:799-834.

North, Douglass C. 1981. *Structure and Change in Economic History*. New York: Norton.

_____. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.

_____. 1991. “Institutions.” *Journal of Economic Perspectives*. 5: 97-112.

_____. 1993. “Institutions and Credible Commitment.” *Journal of Institutional and Theoretical Economics* 149: 11-23.

Oi, Jean C. 1995. “The Role of the Local State in China’s Transitional Economy.” *China Quarterly* 144: 1132-49.

Olson, Mancur. 1982. *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities.* New Haven, CT: Yale University Press.

Stinchcombe, Arthur. 1965.

Opper, Sonja, Sonia M.L. Wong and Ruyin Hu. 2001. "On the Power-structure in China's Listed Companies: The Company Law and its Enforcement." Unpublished paper.

_____. 2002. "Party Power, Market, and Private Power: Chinese Communist Party Persistence in China's Listed Companies." In *The Future of Market Transition*, edited by K. Leicht. Research in Social Stratification and Mobility 19 (Special Issue): 105-138.

Shan, Weijian. 2003. "Living on Borrowed Growth." *Wall Street Journal*, October 7th.

Shibutani, Tomatsu. 1978. *The Derelicts of Company K: A Study of Demoralization*. Berkeley, CA: University of California Press.

Steinfeld, Edward S. 1998. *Forging Reform in China: The Fate of State-Owned Industry.* Cambridge: Cambridge University Press.

Stinchcombe, Arthur. 1965. "Social Structure and Organizations." In *Handbook of Organizations*, edited by James G. March. Chicago: Rand McNally.

Swedberg, Richard. 2004. "The Economic Sociology of Capitalism: an Introduction and Agenda." In *Economic Sociology of Capitalism*, edited by Victor Nee and Richard Swedberg. Princeton: Princeton University Press.

Walder, Andrew G. 1986. *Communist Neo-Traditionalism: Work and Authority in Chinese Industry.* Berkeley: University of California Press.

_____. 1995. "Local Government as Industrial Firms: An Organizational Analysis of China's Transitional Economy." *American Journal of Sociology* 101:263-301.

Wang, Guiguo and Roman Tomasic. 1994. *China's Company Law: An Annotation*. Hong Kong: Butterworths Asia.

Williamson, Oliver. 1975. *Markets and Hierarchies: Analysis and Antitrust Implications*. New York: Free Press.

_____. 2000. "The New Institutional Economics: Taking Stock, Looking Ahead." *Journal of Economic Literature* XXXVIII: 595-613.

Ye, Zhengpeng and Liang Shangmin. Ed. 1999. Twenty Years of Fiscal Reform in China. (*Zhongguo Caizheng Gaige Er'shi Nian Huigu*). Beijing: China Fiscal Economic Press.