China's institutional architecture: a New Institutional Economics and Organization Theory perspective on the links between local governance and local enterprises

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Abstract:

Building on the literature on fiscal federalism, we find that for the majority of Chinese firms the local state matters more than the central state, based on three core elements of China's institutional architecture: local regulatory autonomy, informal enforcement of property rights, and networks between state organizations and entrepreneurs. Three findings deserve attention. First, informal institutions matter. Second, property rights can be protected without a strong central state and formal institutions. Third, at local level property rights protection depends on performance. While in the "West" property rights are independent of usage of assets, local government agencies reward good performance with property rights protection and contractual security. We propose concepts derived from New Institutional Economics and Organization Theory to explain the institutional logic of this situation.

Descriptors:

institutional change, organisational forms of firms, capabilities, informal sector, diversity and convergence of institutions.

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Introduction

This paper summarises recent findings on China's institutional development and argues that an institutional approach explains China's transition path and corporate situation better than the neo-classical or the cultural approach. Based on the Chinese local experience, we propose to add the concept of institutional architecture to North's concepts of institutions and organizations. Organizations, e.g. entrepreneurs, firms and political agents, in the words of North (1990), are the players of the game; institutions provide the rules of the game. Institutional architecture articulates the higher order rules that govern the development and evolution of institutions. These meta-rules are generally taken for granted, for example, in the form of the rule of law, the enforcement of property rights by the central state and forms of legitimization (be they democratic or authoritarian). Where these standard elements of an institutional architecture cannot be identified or are found only in rudimentary form, such as in China's weak rule of law, unclear property rights and lack of democratic legitimization, the system is seen as incomplete or in transition towards a standard Western model. The question whether the institutional architecture in a country such as China has its own economic rationale is hardly raised in the major research works on public and private governance (Yang 2004; Tsui *et al.* 2004). Building on the literature on fiscal federalism (Qian 2000), we propose that China's institutional architecture has its own specific features which rest on the local state more than on central authorities and can be characterised by local regulatory autonomy, informal enforcement of property rights, and local feedback mechanisms between state organizations and entrepreneurs.

Coming to terms with China's economic transformation has been an iterative learning process as major literature reviews reveal (e.g. Tsui *et al.* 2004). The neo-classical reasoning is to "get the prices right" and trust the spontaneous development of markets (e.g. Lipton and Sachs

1990). The cultural perspective has a long tradition in claiming that economic rationality and behaviour based on Confucian values are mutually exclusive and that culture takes precedence when it comes to explaining China's economic development (Hofstede 2001). Theories and approaches which consider institutions and institutional change are only recently gaining influence in explaining economic transformation in China and elsewhere (for example World Bank Report 2002; also Naughton 2007). While the shift to new institutional economics (NIE) provides new tools to analyse China's complex institutions, the resulting analysis also reflects back on the conceptual adequacy (and partial inadequacy) of NIE. This paper attempts a constructive critique of NIE in its widest sense, in particular, by pointing out the useful contributions of organization theory as developed within management science.

In this context, China's transition economy poses empirical as well as terminological problems. The term "firm", for instance, relies on a set of implicit assumptions about what a firm is, what its functions are, and how it relates to its legal or social environment. Yet, to require that a firm in China has to conform to the familiar firm of management science textbooks would limit the analysis to a very specific subset, in this case mostly foreign firms. By standard definition, a firm is an autonomous organization controlled by identifiable economic actors entitled to conclude contracts, select business partners, and co-operate or compete with others. In China's current environment, a firm is constituted when an organization registers as a firm. Whether such a firm is an independent economic actor and whether its growth reflects economic performance cannot be concluded without further information. For example, many private businesses register as a collective organizations and are controlled by or subject to intervention by local authorities. In most Chinese listed firms, equity shares are non-transferable with the effect that underlying government ownership is more influential than shareholders trading on the domestic stock exchange.

The cultural perspective starts (and ends) with the assumption that organizational features find their explanation in Chinese culture, leaving aside the administrative and political details of the People's Republic of China (Hamilton 2006). The NIE approach, in contrast, insists on detailed description and on mapping China's different institutional environments from scratch. This involves empirical identification of economic actors, organizational forms and of the institutions that link economic actors and organizational forms to each other and to their social environment. Empirical evidence is indispensable, as many rules are not codified or formulated. Official Chinese statistics, legislation, government and Party documents are only of limited use in identifying the specific features of China's institutional landscape, as official sources tend to reflect inherited biases of an administratively controlled centralized economy and disregard the role of informal institutions.

In general terms, the difference between the cultural and the NIE perspective can be summarized as follows: the former assumes that Chinese people behave differently because they are subject to different motives, norms and values which are perpetuated by creating institutions that reflect this inheritance. NIE claims that different forms of behaviour refer to different constraints; heterogeneity exists if and when differences in (exogenously) given constraints can be observed to the effect that the persistence or change of institutions depends on changes in constraints.

To integrate the results of empirical research in China into the main body of knowledge is an academic exercise far beyond the scope of one article. We will limit ourselves to the basic concepts for modelling economic behaviour and institutional architecture with a particular focus on coordination by networking. Based on examples of current institutional research and our own field experience from interviewing approximately two hundred entrepreneurs, managers and local officials about the life histories of firms at county and township level in

China's most developed provinces, we will examine the explanatory value of the dominant approaches in NIE. Our discussion will center on three topics: economic behaviour, coordination of economic activities, and institutional architecture. We conclude by emphasizing that *institutional architecture and endogenous institutional change* are fundamental for understanding economic change in general and in China in particular: a research agenda to which evolutionary economics and organizational theory promise additional insights**.**

Behaviour and strategy in transition

Ever since Hofstede (2001; see also Redding 1990; 1996; Hamilton and Biggert 1988), the usual assumption of rationality has been challenged by advocates of the view that Chinese economic behaviour is steered by cultural rules and codes derived from Confucian values. It is argued that the collectivist nature of Chinese society prompts people to go for collective action through networks (*guanxi*). People are said to expect monetary or non-monetary returns in the long but not the short run, while individual achievement is measured in terms of it contribution to the status, size, and performance of the group as a whole.

However, the rationality assumption is a far more powerful analytical tool, not because all Chinese act rationally (or act rationally all the time), but because such a model allows explanations for observable behaviour that can be "tested" (Krug and Polos 2004). *The China experience enriches our understanding of homo oeconomicus by acknowledging social capital and tradition as part of economic behaviour.* Economic calculus describes how economic actors discriminate between alternative courses of action, but cannot define the alternatives, usually assuming they are exogenously given). Detecting and evaluating alternatives is however a crucial economic activity and one in which human and social capital play major roles. Both the competence of managers and the accumulation of business information influence the choice of individuals and firms in constructing viable courses of action and evaluating expected returns or risks attached to each alternative. This competence depends on the social capital of managers of firms, in form of specific knowledge of (1) business routines and practices; (2) political and market information; and (3) finding matching business partners.

Decisions that seem to be based on cultural norms often enough find a rational explanation once human and social capital is accounted for. For example, local embeddedness can be seen as evidence of strong local ties and traditional notions of loyalty associated with the native village. Yet, life histories of firms point to the familiarity with potential business partners and local business practices, and the continuing protection of assets and contracts offered by local government agencies or elsewhere. These institutional advantages add up to transaction cost-advantages that larger but riskier unfamiliar markets cannot easily compensate for (Cheung 1969).

In an environment where regulation, prices or business opportunities can change quickly, to opt for courses of action that allow speedy response to changes in prices or profit rates is a rational strategy. Thus, for example, entrepreneurs and firms anticipating quick changes in information, but also in relative prices and political constraints (Boisot and Child 1996; 1999: Luo and Chen 1996) build up productive slack in the form of physical, financial and social capital in order to "keep their options open", so to quickly move into more profitable industries.

To sum up, the China experience confirms the rationality assumption once we include human and social capital in economic models and acknowledge tradition as a means of selecting (and evaluating) alternative courses of action. In this way, we can integrate insights from economic sociology, industrial ecology, and innovation literature into the NIE framework.

Networks as business networks

In China, coordination problems and networking are often seen as synonymous. Yet, in economic analysis (Hendrischke 2007) Chinese business networks are neither family based organizations using trust to coordinate economic activities, nor are they based only on their ability to overcome constraints imposed by an adverse political environment (Gold et al. 1998: Hamilton 1996; Yang 1994). Rather, they can be seen as a rational organizational response to an environment where the firm as a legal person can only rely on a limited scope of constitutional and legal protection (see also Xin and Pearce 1996; Carney 1998). Economic actors in such an environment require the ability to mobilize resources across a range of local organizations and power holders. As these local organizations and power holders are not only politically motivated, but have an intrinsic public or private economic motivation, local economic actors have to be able to involve them in their economic activities and ensure that they contribute their resources on a long term basis and receive adequate compensation. At the same time, economic actors prefer a minimum of administrative interference in economic activities. In this institutional environment, public-private networks are much better equipped to achieve all these objectives than a legal entity such as a firm. The same applies to the coordination among private individuals intent on establishing and expanding business relations. In the absence of legal guarantees, networks serve to co-opt private partners help to enforce claims across jurisdictional borders. This makes them superior to weakly enforced legal mechanisms. Instead of firms engaging in networking activities, we find networks as economic actors engaging in the establishment of "open border" firms that suit their specific requirements. From an organization theory, perspective the fluidity of firms finds its explanation in the control of social and political capital as a core competence. If social and political capital can easily cross industrial and jurisdictional borders, assets can be moved quickly to exploit new opportunities.

As argued elsewhere (Hendrischke 2007) and in contrast to both the previous NIE literature and the cultural perspective, *networks are ex ante devices, which by aligning the interest of members limit ex post opportunism*. It can be shown that (1) economic actors are seeking out existing and initiating new social relations that can be mobilized for economic purposes. 'Business' networks that fail to produce sufficient returns are de-activated and revert to a social function. (2) Familiarity (or the "old friend" links) serves as a screening device, while trust and reputation offer enforcement tools. (3) One way of effectively aligning the interests of network members or mobilising further connections is to convert a network's tangible and intangible assets (human, financial and social capital) into a firm where corporate governance and legislation establish ownership and rights for owners, managers and investors. Another way to align the interests of present or 'dormant' (i.e. not yet activated) members is to have a rather loose structure and open entry around 'pure' social activities, such as banqueting, in order to stimulate the exchange of information and generate hard-to-exchange knowledge, while setting joint standards for quality of goods and appropriate behaviour. Therefore, in contrast to the NIE-literature, networks are not predominantly an enforcement device facilitating private exchange by restraining moral hazard. Instead, they are an *ex ante* device which helps to pool resources, find matching business partners, facilitate learning, and allow for the exploration of new business technologies and opportunities. *Corporate governance takes the form of mobilizing resources and ensuring capabilities such as access to political and market information, sharing of (tacit) knowledge and learning.* In contrast to sociological approaches (still the best: Granovetter 1985) these networks are not based on weak or strong ties, but form weak or strong ties according to the purpose ahead. Constrained neither by socio-demographic factors (as the cultural perspective claims), nor by relation-specific risk (as TCE would claim), networks reveal a considerable adaptive capacity that allows them to quickly move resources from one form of production to another, while spreading the associated costs of such transfers (Krug and Kuilman 2007).

These empirical observations coincide with insights from modern organization theory, which has developed new concepts for analysing corporate governance (Blaire 1995): trust, alliances, reputation (Nooteboom 1996; 2004) and corporate learning. The China experience offers supporting evidence for some of the general criticism of TCE (Dow 1987). Aside from the general argument that TCE dismisses technical reasons for network formation (e.g. Englander 1988; Milgrom and Roberts 1990) and externalities on the demand side, the China experience suggests the following aspects to be included in economic analysis.

Power and authority relations. Networks as business communities where firms (Ghemawat and Khana 1998; Weidenbaum and Samuel. 1996; Rauch 2001) are established to overcome information, or enforcement problems alone, are too narrowly conceived. Observing that networks serve as a means for co-opting local government agencies (Boisot and Child 1988; Nee and Peng 1994; Park and Luo 2001; Peng and Luo 2000; Krug and Hendrischke 2003; Hendrischke 2004), we can argue that the closer the ties with local politicians or administrators, the more productive the network (for a thorough analysis see Tsai's study on the informal banking sector, Tsai 2002). From this perspective, confining the analysis of hierarchical relations in TCE to the consequences of the opportunism of employees (or subordinate units) is a limitation that needs to be revised (Dow 1987) to account for institutional structures, which encourage collusion between hierarchies. In China, patron-client relations (e.g. Oi 1995; Walder 1995) are found between local firms and government agencies, which simultaneously are expected to supervise the business activities of firms.

Those in power can use internal information for their benefit, impose self-serving incentive schemes, and use fiat to settle disputes to their own advantage (Nee 1992; Boisot and Child 1988; 1996; Krug and Hendrischke 2003). These findings cannot be dismissed as transitory; they suggest a need for better integrating the literature on principal-agent relations, rent-seeking and corruption, as well as adding the analysis of state seizure or state capture (Frye and Shleifer 1997; Nee 2000; Frye 2002; Shleifer and Vishny 1994; 1998; Vickers and Yarrow 1991; Laffont and Tirole 1991; also Dixit 2004) to the analysis of institutional change.

Social relations. Unlike TCE, which discounts identity and past relations (see Granovetter 1985), the China experience shows that organizations are not neutral with respect to the interest of their economic actors. Thus, Chinese networks indeed center on personal relations, which may, or may not be mobilized for economic purposes. Once the collaboration has outlived its productive usefulness, the business side of the relationships is de-activated, while the social side remains (Hendrischke 2007). It is this activating – de-activating mechanism, which allows economic actors to adapt quickly to changing economic situations at low cost, since the de-activation does not imply the end of a contract, let alone a break of the social relationship. The advantage of personalising business relations (Coleman 1990) is that social sanctioning mechanisms can be used for economic purposes. As the management science literature has shown, trust, reputation, and hold-ups all play a role when it comes to harnessing such a form of governance (Nooteboom 1996; 2000). To identify substitutes for the public enforcement of contracts (or other forms of inter-firm relations) and to explain the functioning of these substitutes illustrates the differences in the development of a private sector not only in China but also in other transition economies.

Capabilities and learning. From the perspective of organisation theory, the analysis shows that *the expansion of firms and the development of industries follow social and political capital, i.e. capabilities, here understood as capabilities to recombine assets.* The speed of economic transformation relies also on learning, relying on – amongst other things – the productive slack needed for innovation, knowledge creation, and experimentation; in short, on the building up of learning capabilities. One of the advantages that the networks described here offer is that they function as repositories of productive slack. This function escapes TCE with its static concept of the firm that does not address the question of how a firm can move from one hybrid to another, let alone create new hybrids. The TCE concept relies on a typology of firms that is determined by external factors (asset specificity, frequency of contacts etc.). Findings in China support the criticism of the so-called Competence approach (Teece and Pisano 1994, see also Langlois and Foss 1999; see also Guthrie 2005) and evolutionary economics (Hodgson 1998) that TCE offers an insufficient set of variables for explaining the emergence and diversity of organizational forms. A concept of dynamic governance costs is needed to account for the costs for generating competence as well as transferring capabilities to others - if by doing so individual performance can be increased (Dosi *et al*. 2000).

The generation of capabilities to a large part depends on the ability to share knowledge, and creative routines that are available to all firms at low costs. This takes us to the broader institutional incentives required for the generation of capabilities and learning. Here, local embeddedness unfolds its growth-stimulating value when local government agencies offer property rights protection in return for good economic performance by local firms. This departure from standard legal tradition, where property rights are independent from the usage of assets, requires a closer look at institutional architecture.

The institutional structure of China's emerging business systems

Looking at China's business environment from the individual or firm's perspective, three features stand out: localism, social embeddedness and organizational choice. While these three elements are building blocks of the institutional architecture, there is an underlying mechanism which needs to be understood first in order to be able to explain how the three features influence the formation of institutions (Kornai et al. 2003; see also Meyer and Peng 2005). This underlying mechanism is the interplay between *formal and informal* institutions.

For China, the simple juxtaposition of formal and informal institutions does not make sense and needs to be expanded to include intermediate levels of formality, and the transition from one to the other. The best analogy may be that of soft and hard institutional constraints. In economics, we observe soft institutional constraints when constitutional and legal constraints (for example, the enforcement of property rights) exist at central government level but their implementation is subject to local discretion, or when local authorities assume authority over aspects of enterprise operations without a legal basis, simply on an informal but nevertheless authoritative basis. We might call these rules 'semiformal', in particular when Communist Party cadres are involved. Their authority is not strictly formal in the sense that functions they assume may actually be defined as local government tasks. On the other hand, their authority is not informal, because they form a constituent part of local governance. Nor is their modus operandi a hybrid one, because it has its own institutional logic when in operation. This wide spectrum of formality enables localism, social embeddedness, and organizational choice to structure China's economic institutions.

The finding that informality is a matter of degree rather than part of a formal-informal dichotomy raises several questions when it comes to modelling the institutional architecture:

(1) *Causality.* Do localism and local social capital lead to a specific form of organizational choice, or does organizational choice lead to localism? The Fiscal Federalism model (Qian 2000) suggests that localism and jurisdictional competition predicate organisational choice; yet studies which focus on behaviour of firms indicate that social (and financial) capital leads to localism (for an excellent study of the foreign trade sector see Huang, 2003). In other words, the institutional constraints defined by Fiscal Federalism are either not rigorously enforced, or the "weak central government" is in fact a euphemism for local autonomy and diversity which require other models for analysis. The answer to this questions is related to the issue of

(2) *Hierarchy.* The relationship between sub-provincial localities (including local business systems), superior political and administrative entities and the central government is under-researched. For example, is the observed diversity in business systems and organizational forms the result of under-institutionalized, ineffective principal-agent relations asking for better management and management tools? On the other hand, is there a lack of consensus building in a non-democratic environment (where constitutional separation of powers and universal suffrage are missing)? This question dominates the *state-seizure vs. state capture-* or *Grabbing hand vs. helping hand* controversy (Frye and Shleifer 1997; Fry 2002), where there is no agreement even on the effects of vertical competition. For China, rent seeking by business communities or strategic alliances between firms and local politicians (acting as lobbyists) fail to explain competitive dynamics and economic growth, and additionally clash with the Fiscal Federalism model. Political science models of multi-layered government work within (mostly European) political markets, but fail to explain how this form of institutional

architecture could emerge in China. In short, rent-seeking approaches dismiss too many political factors, while multi-layered government models dismiss too many economic factors as explanatory variables.

(3) *Replication.* Tradition or remembered (business) routines draw attention to the fact that the expected functional value of institutional alternatives need not be the decisive factor in institutional choice. If two alternatives result in identical effects, such as expected returns, then *persuasion* or *appeal* might be the additional reason for overcoming inertia or indifference. This type of (supplementary) appeal, whether remembered or replicated, can explain organizational and institutional variety (Aldrich 2001). In China's case, there are obvious historical parallels between contemporary and traditional forms of local administration and local autonomy to be explored by evolutionary theory.

(4) *Scale.* Depending on the chosen unit of analysis, different outcomes are arrived at. Focusing on the aggregate level or central state policies dismisses underlying institutional and economic developments. Such analysis in particular misses the dynamic at the micro-level where individual economic and political actors search for organizational and institutional solutions to better adapt to an increasingly competitive economy and a fragmented institutional environment. More importantly, such an analysis fails to "endogenize" the market (which is assumed to emerge spontaneously once the central government has committed itself to refrain from intervention). The China experience indicates that markets are the outcome of private exchange, as recently also acknowledged in management science (Hamilton 2006), which in turn depends on choosing the right institutions, namely those which help to mobilize entrepreneurs and resources while solving the moral hazard problem (Cao *et al.* 1997). The problem of scale is also connected to the kind of economy one attempts to explain: the official/formal or the total economy. Whether the expansion of trade occurs in the formal or informal sector (the latter being dismissed as evidence for "poor" legislation) is not an

> economic argument, but rather points to deliberate study of one subset of the population at the expense of others. Undoubtedly, the analysis of the informal sector is more complicated, and time consuming; and requires research methods, which are not part of the general tool kit in economics. Yet, the effort to apply alternative methodologies, such as institutional game theory, interviews or "analytical narrative" (Bates 1998; Greif 2006) seems a low price to pay when compared to the loss of insight that follows from concentrating on the formal economy only.

The standard Western perception of China's institutional architecture rests on political assumptions, which do not necessarily apply to China's economic institutions. One such preconception is the predominance of the central state and its constitutional authority to define institutions at the local level. Another preconception is that social and political embedding of institutions occurs at central level, i.e. the notion that legitimization is a prerogative of the central state and transferred down to local state levels. A third preconception is that the organizational form of economic actors is seen to be the firm. These preconceptions are shared by official Chinese accounts which tend to focus on the country's formal institutions and the central political set-up. For China's local economies, where the majority of enterprises are found, this framework needs to be reconsidered.

How misleading national laws or the constitution can be as indicators of institutional change is illustrated by the issue of formal private ownership rights. From a legal perspective, Western observers agree with the official Chinese view that China's thriving market economy has no protection of private property rights. Indeed, up to 2004 private property rights were guaranteed neither in law nor by the Constitution. Yet this does not mean that property rights were lacking. At the local level where property rights protection mattered most (Oi 1995; Walder 1995; Krug and Hendrischke 2007), local governments depended on increasing revenues. Being able to lease out local economic assets, they had the means and incentives to protect well-performing local firms by offering them contractual security on an informal basis. In other words, the Chinese case does *not* prove that property rights are unnecessary for the development of a market economy. *China's example proves that property rights protection does not need a strong central state.* This view coincides with other findings that property rights protection and contractual security do not need a strong central state (Dixit 2004), but can be organized by communities (Ostrom 1990), social groups (Greif 1993; 1998), or via private ordering (Ellickson 1991; Milgrom *et al.*1990). The claim that ownership in China is unprotected refers to the formal legal set-up rather than the institutional situation, as the legal perspective disregards property rights protection through the "informal sector". A large part of China's institutional reality is not immediately obvious. In particular, informal links between economic actors, such as township and village enterprises (TVEs) and local governments as well as links between local government agencies and higher layers of government are not represented by official accounts (Rozelle and Li 1998; Rozelle *et al.* 2000; Li and Rozelle 2003; Li 2005; Ong 2006).

The weakness of formal rules shows at the operational environment of local economic actors. At local level, central authorities give way to informal institution building that involves local economic, political and social actors. The local state builds and protects institutions such as property rights not as an agent of the central state, which issues and codifies formal rules, but based on economic self-interest and local purposes. In this informal institutional set-up, local Communist Party cadres play a crucial role in mediating between economic and broader societal interests. They are not tied to ideological prescriptions or the rigid formal government processes, but have sufficient authority to make credible commitments in the interest of strong local economies.

In China, the central state does not have a monopoly on institution building, and institution building is not primarily defined through the Constitution. Instead, economic institution building is devolved to the local level. This has important consequences in that the institutional unity of the state rests less on a formal conformity of institutions than on an informal political consensus maintained by the Communist Party - the inheritor of long-standing institutional practices and active contributor to local economic policies. The Communist Party maintains a political consensus that drives economic policies and is able to accommodate local differences in economic policies and institutions. Local differences emerge through the local embedding of institutions with the active involvement of local Party organisations. In terms of process, local economic institutions in the first instance evolve endogenously and take exogenous influences (including central policies) only as a frame of reference. More specifically, local institutions evolve through coordination between economic actors and local social and political agents.

This institutional set-up necessarily impinges on organizational forms, in particular the structure of local enterprises. Local entrepreneurs do not have the constitutional and legal back up that enables them to concentrate on the market alone. Instead, *they face the commercial market as much as the institutional market* (Krug 2007). Both require entrepreneurial attributes in terms of financial capital, social and human capital, alertness and creativity, a point taken up by the literature on competence building (*e.g.* Teece and Pisano 1994; Dosi *et al.* 2000; Langlois and Foss 1999), but also part of the research agenda on yardstick competition (Besley and Case 1995; Belleflamme and Hindriks 2005). Evidence suggests that interpersonal coordination is better able to take care of these tasks than individual action. Modelling this type of interpersonal coordination as networks leads to useful insights in management science (e.g. Nooteboom 1996; 2000), but for China we need to keep in mind that, unlike Western networks, the underlying unit is a collective actor which can assume different legal forms as required by the institutional environment. The focus on the firm as the main economic organization and actor rests on the underlying assumption that economic actors are defined as legal entities. This is a constitutional rather than an economic assumption: in the local Chinese context, economic actors need to be socially and politically embedded; the legal constitution of the firm is secondary to its social and political constitution.

Conclusion: Expanding the NIE agenda by bringing organization theory in

From a NIE perspective, three findings deserve attention. First, property rights protection does not need a strong central state. Local autonomy can serve the same purpose, in particular in an environment where local governments need to compete with each other. Second, the informality of institutions is a matter of degree. The alliance of firms and local government agencies creates situations and scope for actions that lie between informal activities (or property rights) and formal activities. Third, property rights protection in this environment depends on performance. While in the "West" property rights are independent of usage of assets, local government agencies reward good performance with property rights protection and contractual security.

Likewise the perspective of organisational theory draws the attention to the following three findings: First, corporate governance is seen as a means to attract and ensure valuable capabilities such as access to political or market information and the sharing of tacit knowledge. Second, the fluidity of firms reflects social and political capital as the core competence of networks. As social and political capital can be employed by a variety of firms and is limited by congestions rather than by scarcity, firms are less embedded in markets for goods and services or depending on the financial sector. Third, the expansion of firms follows social capital, here seen as the ability to mobilise financial means and resources outside of public capital or other markets. To dismiss "back alley-banking" as a transitory phenomenon is therefore misleading, as this 'informal sector' has proved to be effective enough to aliment lasting growth rates in the past.

The Chinese example shows that the NIE approach rests on strong institutional assumptions which are normally not made explicit, but become evident when major elements of these assumptions are missing in a specific setting. In China's counties and townships, where the majority of businesses and firms are located, such missing elements are centrally implemented constitutional and legal rule and nationally legitimized and accepted economic institutions. Paradoxically, because of the predominance of informal institutions, we observe an economy which on its formal surface seems very similar to the textbook model. From this perspective, it is then argued that gaps and inadequacies, such as widespread corruption, are simply "imperfections", which will be remedied in the course of further reform.

The Chinese case poses a challenge to NIE and organization theory to refine analytical procedures by reflecting on inherent institutional biases. NIE has opened up a wide field of economic analysis by drawing attention to the coexistence of formal and informal institutions (North 2005). By operating under Western institutional assumptions, the hierarchy of institutions in standard NIE perception is relatively flat, as many institutional functions are subsumed under constitutional rule. In contrast, a special case such as China, where constitutional rule is not implemented at local enterprise level, serves to show that deeper institutional analysis is needed. More specifically, in order to explain China's alternative and largely informal institutional environment, NIE needs to develop a general theory of institutions able to link aspects of institutional governance (i.e. how institutions are made), with the social embeddedness of institutions and the impact of institutions on the formation of economic actors.

To sum up: In this paper, we have used institutional architecture to point to rules of local institution building. The China case shows that the 'firm' is not an analytical but an empirical concept that easily convolutes economic and legal aspects if taken out of its specific institutional context. The rapidly growing debate about the "nature of the firm" (e.g. Williamson 1985; for an organization theory perspective see Aldrich 1999; Borgatti and Foster 2003, Milgrom and Roberts 1990, Uzzi 1996; Holmström and Roberts 1998), which models governance structures and organisational form as outcomes and not as given, finds its empirical correspondence in our notion of organizational choice, with obvious practical consequences. Once it is shown that institutions and organizations co-evolve and that their co-evolution is governed by meta-rules of institutional governance or institutional architecture, the standard assumption that reform paths are defined by convergence no longer holds. Instead, we need new approaches to understand endogenous and exogenous factors. For the former, the potential of endogenous institutional change needs to be explored on the basis of existing endogenous institutions and their specific path dependency. This is a task for evolutionary economics (Nelson and Winter 1982; Hogdson 1998) and organisation theory which analyse capabilities and innovativeness of firms from a co-evolutionary perspective (Lewin *et al.* 1999; Boisot an Child 1999). For the latter, NIE provides a conventional approach, but, as we are dealing with local settings, exogenous change comes from two outside sources: first, from domestic central institutions and, secondly, from external sources. This is by no means a purely theoretical demarcation. The logic of this point indicates that local economic institutions, when exposed to external (foreign) constraints, show similar responses as to domestic central constraints, namely a tendency to negotiate the implementation with the economic and political principals concerned and within their local networks. In practical terms, we surmise that local economic and political actors will regard international competition or WTO imposed restrictions as soft and negotiable constraints in the same way as they would central government legal and economic policies. Of course, this does not rule out convergence of institutions, but convergence is likely to occur through gradual embedding of external constraints into local political and economic settings rather than by way of top-down implementation.

The usefulness of NIE in explaining economic transition rests not least on its ability to absorb new empirical evidence into new conceptual tools, such as institutional architecture, which help broaden the scope of familiar concepts such as interactive choice, organisational and institutional co-evolution innovation and convergence. Coming to terms with China is an important part of economic globalization. Any institutional theory that claims general applicability needs to be able to incorporate the specifics of China's situation in its theoretical framework.

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