

## China's Informal Institutions: the Case of Private Enterprise in Wenzhou

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### Introduction

The private enterprises have been growing at a rapid pace during the last 20 years in China. The private sector now accounts for 62 percent of the total economic activity, contributing 71 percent of gross industrial output (China's Bureau of Statistics, 2008). Despite this impressive growth, the private sector is still facing formal institutional restrictions, such as limited state bank loans, heavy tax burdens, higher requirement for registration and licensing, competitions from state-owned counterparts, and so on (Bramall, 2008). The survival and prosperity of private enterprises, to some extent, have to resort to the adaptive informal strategies by bending governmental rules. One of the Chinese cultural byproducts, *guanxi*, that is, an interpersonal network, plays a significant part in this process. Previous research has shown that *guanxi*, especially the patron-client ties, can help entrepreneurs reduce potential risks, facilitate business transactions, create alternative financing channels, and promote business success (Leung and Wong, 1995).

In this study, I use Wenzhou, a major city in southeastern Zhejiang province, well known for its prosperous private industries, as a case to examine how adaptive informal institutions work in the Chinese business and political arenas, and how the informal actions encroach and change the formal ones. With a population of 7,645,700 in 2007 situated in a mountainous region, Wenzhou has 2 satellite cities and 6 counties. Dubbed as the "birthplace" of the Chinese private economy, Wenzhou has been the first to establish individual and private enterprises as well as shareholding companies, serving as a successful model for vibrant business activities. The analysis of this typical case can provide us with a lens of the institutional environment in southeast China, and analyze the nature of China's ongoing transition.

### Theoretical Framework: the Dynamics between Formal and Informal Institutions in China

Research on institutional transformations has been focused on not only the drastic driving forces that shift the developmental direction of a given political system, such as revolutions, wars, foreign invasions, and economic crises, , but also those gradual, incremental changes that take place in ordinary periods, where theories of sequencing and institutional layering give causal explanations on institutional changes from a structural or behavioral perspective.

To explain regime durability and changes, Pierson (2004) distinguishes two types of path dependency: "self-reinforcing event sequences" and "non-reinforcing event sequences". The former refers to an enduring power effect of political institutions that have been established by

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political authorities in the earlier formative period, and the latter refers to certain reactive events that occur later and as a result, diverge the original direction of the earlier developmental trajectory. While the first type might explain much of the institutional continuity, the second type provides plausible interpretation on nonlinear development path and institutional changes (Pierson, 2004).

Moreover, the theory of sequencing explains institutional change from a structural point of view, while the theory of institutional layering interprets the transformation issue in terms of behavior. This theory views the society as a configuration composed of a variety of institutions, where actors are very much likely to have conflicting interests and the relations between different institutions might be inconsistent. When there is “friction among multiple political orders”, “significant extraordinary political change” might happen (Lieberman, 2002). Thus, important institutional transformations might occur in ordinary interactions between individual actors.

Incorporating both theories of sequencing and institutional layering, Tsai (2007) proposes an informal institutional approach to understand the ongoing institutional transformation in China (Tsai, 2007). In his observations of the development of the private sector in China, he argues that those top-down decisions that are apparently dictated by the official organs are very likely to result from a lagged reaction to everyday interactions among various grassroots actors. Because of the enduring power effect, the established formal institutions, known for the official rules, regulations, policies and legal procedures, have constrained “the range of officially permissible behavior”. Yet in practice, the inconsistency of the formal institutions and the loopholes of the mandates make infringement and adjustment viable. Actors from multilayered institutional environment usually use adaptive strategies to transcend the scope of formal institutions and thus form alternative living space called “adaptive informal institutions”. In China, because of the discouragement from formal institutions, economic actors and local officials have to resort to adaptive informal institutions to promote development of the private enterprises—usually in ways of satisfying “new licensing and financing needs”, “changing relations with workers”, and creating “new opportunities for generating revenue.” By this means, formal institutions are transgressed and distorted over and over again (Tsai, 2007).

Usually informal institutions are adopted when there is a gap between formal intuitions and “practical interests and desires”. As Tsai points out: “adaptive informal institutions and the creators of informal adaptations have convergent interests. By definition, this means that while local state and non-state actors benefit mutually from the resulting adaptive informal institutions, those arrangements transgress existing formal institutional mandates (Tsai, 2007:p39).”

Informal institutions are usually used to account for unintended consequences originated from formal institutions. There are certain hidden potentials in this practice, such as customs, norms, values, cultural inheritance, that serve as “soft” forces to support or counteract the formal rules. Because of the insidious and subtle characteristics, the informal institutions might be more enduring and far-reaching to influence human perceptions and behaviors. Sometimes they can even undermine the legitimacy of formal institutions. In the development of the private sectors in China, official legitimacy comes long after the adaptive strategies initiated by those local political and economic actors to gain support for their business.

To sum up, institutional transformations can result from daily interactions among actors from multilayer institutions. The encroachment of formal institutions derives from informal institutional forces—such as historical experience, collective norms, and cultural heritage. Once the frictions between informal institutions and official regulations become irreconcilable, or some informal institutions start to adopt formal rules, there might be certain significant change in formal institutions. To understand how informal institutions work in China, it is better to first understand an important cultural and practical ethic —*guanxi*.

### **Guanxi and its Impact and Practice in China**

Guanxi refers to an interpersonal network that contains “implicit obligations, assurances, and understanding” (Yang, 1994). It is reflected and performed in everyday life of Chinese people in every aspect of Chinese society. The establishment of guanxi philosophy can date back to the sixth century BC when Confucius codified the social rules, values, and hierarchical structures in a clan-tied society. Born in a period of frequent wars and famines, Confucius had witnessed the severe suffering of ordinary people and thus wished to reestablish social order by his philosophy (Nan, 2000). Confucianism shows the main concern on social harmony and a strong, orderly hierarchy (Wank, 1996). It is based on the principle that human beings are relation-oriented and individual's identity and responsibilities can only be fulfilled in the relationship with others. There are five important relations that a person mostly needs to deal with—ruler and subject, father and son (i.e. parents and off springs), husband and wife, elder brothers to younger brothers (i.e. elder siblings to younger ones), friend and friend. Specific duties are prescribed to each of these sets of relationships, and among the duties, the principle of “filial piety” is the dominant virtue that needs to be practiced. Apparently, filial piety seems to be an obligation to ordain the loyal heart of the inferiors (subjects, sons, wife, younger brothers), yet in fact it is a mutual-responsible bond of both sides in the relation settings (Nan, 2000). For example, on one hand, sons need to love their parents and obey their instructions, yet on the other hand, parents have the duties to provide proper guidance in words and deeds. If the son fails to behave in an expected proper way, his parents are blamed by the whole community. This mutual moral bond embedded in filial piety principle is the core characteristic of guanxi ethic.

Guanxi has the following three characteristics: first, guanxi is transferable. The connection between A and C might come from their common connection with B. The extent of transferability might depend on the strength of ties between A and B, B and C, or A and C (Powell, 1990). Second, guanxi is reciprocal, though might not be exactly equal. In fact, it usually happens when the establishment of guanxi network is between a strong party and a weak one. The unbalanced relationship of the two parties can sustain because of the mutual benefits, or an expectation of future benefits (Alston, 1989). Third, guanxi is utilitarian. Though participants usually proclaim the friendship between two parties, oftentimes, it is rhetoric rather than factual. Deeply rooted in Chinese traditional and contemporary culture, guanxi is widely used as a leverage to acquire certain favors or future rewards.

In addition, the informal, reciprocating obligation embedded in the interpersonal network is called *renqing*, a spin-off related to guanxi. With an emphasis on exchanging favors, *renqing* is the precondition to develop a guanxi network and to use the network for one's personal

advantage. In some occasions, this principle of reciprocity derives from the so-called “value of face” (*mianzi* in Chinese) greatly cherished by the Chinese. The Chinese emphasize gaining prestige by preserving dignity or reputation of all parties involved, which is the important “face” (Hwang, 1987). Thus an investment in good relationship with others carries an expectation of future reward by principle of not losing face.

As an incredibly popular cultural phenomenon, *guanxi* is an indispensable component of Chinese people's life and has even become more influential in contemporary Chinese society. Given the absence of institutional certainty in transitional society, people purposely develop *guanxi* to reduce unpredictable risk (Burt, 1992). Previous studies have shown that *guanxi* has a strong impact on business performance. For business firms, *guanxi* affects the flow of resources and the external environment in which firms interact (Xin and Pearce, 1996). *Guanxi* can also influence financial outcomes, market benefits and competitive advantages (Luo and Chen, 1996; Davies et al., 1995; Tsang, 1998). The effect of *guanxi* network in a company is related to the size of the company, the type of ownership, the amount of investment in *guanxi*, and the inception of the operation (Xin and Pearce, 1996). *Guanxi* can also help build interorganizational networks to enhance the chances of survival and growth of organizations. Organizations connect with their counterparts to acquire new technologies, exchange resources, create shared learning opportunities and transfer professional knowledge (Nohria and Eccles, 1992). Thus organizational performance can be enhanced through the engagement and dedication at the personal level.

Particularly in private sectors, business owners and local cadres use *guanxi* as an informal substitute for formal institutional support. In fact, private companies are faced with more systematic barriers than collective and foreign business in China, such as a lack of access to formal loans or informal financing sustenance. With low initial cost but higher repayment rates, the cost of transactions is usually more than 70 percent of the formal loans. The private enterprises are faced with redundant taxes, exorbitant fees, changeable regulations, and various restrictions with scarcely effective policies for justification. In the meantime, increasing challenges from their rival collective- or state-owned counterparts also have some bearing on the status of the private firms (Garnaut and Song, 2003).

In light of such intense business environment, private enterprise owners rely on some adaptive informal strategies to protect and manifest their own interests. For example, from the late 1980s to early 1990s, the central government enforced “readjustment” policies and aimed to restrict the development of private sectors. The number of reregistered private enterprises in Tianjin was only 660 in 1989, 72.8 percent less than that in 1988. The number of employees decreased by 71.5 percent (Yuan, 1993). However, the private enterprises were not completely phased out. In fact, many firms have camouflaged their private nature by a disguise of collective- or state-owned external operation system, so called “red hat” (Sun and Pannell, 1999). However, this practice was public knowledge, accepted and even supported by the local cadres. The permit and favor from the local government were gained through the collaborative relationship, say, good *guanxi*, between the local authorities and the entrepreneurs.

Due to the fiscal decentralization and tight local budget, local officials allow the lucrative local enterprises to run and enjoy larger discretion in budgeting, aiming at extra tax revenues. Meanwhile, the officials could also collect considerable registration fees from their entrepreneur

friends for changing their ownership status. In fact, local officials play an active role in facilitating the survival and development of the local enterprises. They might spend much time and energy to represent local industries in acquiring technology, materials and funding. As Qi (1990) recorded, "A diary of one official from Shandong rural enterprise management bureau shows that during a one-month period in May 1988, he made six trips to Ji'nan, the provincial capital, one trip to Beijing, three trips to other townships and six trips to various villages." (Qi, 1990) Furthermore, by wielding the administrative power, local governments can also extract profits from the faked collective-owned enterprises, redistribute income among different sectors and gain fund rewards for themselves. The extracted profits can be utilized to fulfill both political and personal purposes—it can be used to subsidize the less profitable companies to accommodate surplus labor force, build public welfare system for local residents, and improve their own material conditions. By offering political protection to local private business, the political cadres also get benefits and responsibilities from their offer. This reciprocal bond between private owners and political cadres was brought about by the good *guanxi* (i.e. relations) of both sides. In a nutshell, *guanxi* as an informal institutional strategy, regulates political and economic actors in their practical arena.

### **Private Enterprise Development in Wenzhou**

A city known for its prosperity of private industries, Wenzhou is one of the frontrunners in China's economic transformation. Located in the southeast corner of Zhejiang province, the mountainous geographic locality and the limited arable land pose a great challenge for resource and sustenance. In the late 1970s, Wenzhou's rural per capita GDP was only 114RMB (\$68) per year, 15 percent lower than the national average (Naughton, 1988). However, only after a decade, Wenzhou became a national hub for its economic boom driven by the private business. The rise of Wenzhou renders insights on how adaptive informal institutions transcend and transform the formal rules, and how *guanxi* network, as a staple informal instrument, facilitates political and economic transactions.

Due to the dense population and resource shortage, Wenzhou's development of private economy began even early in Mao's period when the central control was still very rigid. During the Cultural Revolution, state control over society was considerably weakened in some areas. As a result, individuals and households took alternative strategies for survival. In Wenzhou, peasants began to divide the collectively owned land and distributed to themselves. They also fished, chopped down forests, set up household workshops, and sold products in underground markets, which were perceived illicit during that period of time. Some of the production was focused on the vital materials and energy even not supplied by the state (Yu, 1988). The survival of private economy under state suppression attributes to a body of local cadres' acquiescence and protection. Sometimes the local cadres ended up jeopardizing their own political careers by their shady assistance to these private companies. For instance, in 1956 when the central government enacted collectivization of private property, it met strong local resistance in Wenzhou. The resistance was regarded as anti-revolutionary and a setback to communism, and finally the local cadres who supported the resistance were politically purged (Lin, 1989).

The acceleration of the privatization process in Wenzhou started in late 1978 when the state eased its control over the economy. Beginning with household industry, Wenzhou's private sectors managed handicrafts and semi-mechanical production based on individual household. Its production value accounted for nearly 60 percent of Wenzhou's net industry output since 1984. By 1986, Wenzhou already had more than 10,000 private enterprises (Lin, 1989). The rapid development of household and private industries has transformed the local economic structure from agriculture to commerce and industry. Table 1 indicates that since 1985 the industry and service sectors together have made up two-thirds of the total gross production value of Wenzhou. The development of private enterprises is the driving force of a significant economic transformation in Wenzhou.

**Table 1: The Changes in the Economic Structure of Wenzhou**

Year	Agriculture%	Industry%	Service%
1978	63.4	17.5	--
1980	68.4	26.7	4.9
1984	33.8	47.4	--
1985	31.3	52.55	16.15
1986	29.8	53.5	16.7

Source: Bureau of statistics of municipal government 1987.

### **Building adaptive informal institutions**

The growth of private business in Wenzhou is attributable to the creative utilization of adaptive informal strategies by Wenzhou people. These strategies mainly include ownership concealment, underground labor employment, and local financial market development.

#### *Ownership concealment*

In the early 1970s when the household enterprises were not officially recognized as legal economic entities, Wenzhou people began to operate their private business under the concealment of collective affiliation. In practice, these firms attached themselves to an established collective or state unit, by way of paying a fee for the use of the unit name on the company letterheads and office supplies. More importantly, by getting the official identification, firms are provided with officially issued invoices and bank accounts, as well as income taxes. This ownership concealment became pervasive throughout the late 1970s and 1980s. By the mid-1980s, an estimated 80 percent of Wenzhou enterprises were private affiliated in nature. .

#### *Underground labor employment*

The national regulations in 1981 restricted individual enterprises to no more than 8 employees. However, practically, rural “red hat enterprises” had already exceeded this limit. In Wenzhou, an estimated number of hired workers in household business was 35 on average during the 1980s. Some adventurous entrepreneurs might employ more than 100 or even 200 workers (Yi, 1988). In the mid-1980s, the government policy began to be more tolerable of private wage labor and allowed co-operation between collective and private firms. The co-operative companies were run in the form of hybrid shareholdings by both public and private investors. Sometimes this type of collective firms secretly turned into private ones due to the investment of a large amount of private assets. By this form of hybrid ownership, private firms can employ more wage labors for their business operation. However, the employees were mostly unregistered and temporary under weak and loose legal protection. As a result, these workers were exploited and the turnover rate was very high. This was prevalent until 1988 when the government legislated to sanction private wage labor (Lin, 1989). Despite the legislation, employees in private sectors are still subject to poor rights and inadequate public welfare.

#### *Local financial market development*

One of the fascinating adaptive strategies used by Wenzhou people is to develop its own distinctive financial market. Due to the difficult access to state bank loans, Wenzhou people created their own financial agencies, including self-organized credit associations, underground lenders, and private banks, to facilitate their business. In 1984, the first private bank was opened in Wenzhou despite the opposition from state banking officials. The interest rates in private bank was as high as 9 percent, compared to less than 1 percent on the interests of loans from state banks. However the capital drawn by the private enterprises from the source of private banks or individual moneylenders is as high as 90 percent of the total enterprise assets.

The operation of Wenzhou's local financial market can be seen from one example recorded in Tsai's interview of a private owner:

“After decollectivization, owner Peng had nothing to do, so he started out by processing individual parts of hydraulic valves. To purchase equipment, in 1982, he borrowed 150,000RMB from his friends and family and 5,000RMB from a loan shark at 20 percent annual interest. When he needed additional working capital in 1996, he started borrowing in 10,000 RMB increments at 21 percent annual interest from a rural cooperative foundation. Owner Peng explained that rural cooperative foundations were readily run by private individuals and that he could never get a bank loan without connections (*guanxi*). ‘Besides’, he added, ‘It would take too long to borrow from a state bank because they want to investigate everything.’” (Tsai, 2007)

#### **Developing *guanxi*: benefits of the local government**

The prosperity of ownership conversion, the underground labor employment and the local financial market development is available greatly attributable to local authorities' protection. Entrepreneurs always had good *guanxi* with government cadres. This *guanxi* can come from either the official's direct personal benefits or indirect political gains or both. In the ownership conversion process, local cadres can get a considerable amount of conversion fee from their

entrepreneur friends. This type of relationship is called patron-client relations reinforced by personal ties with authority to expedite the economic activities.

Another personal benefit comes from the increase of personal assets for local officials. Many newly constructed apartment buildings located in commercial areas are owned by these local cadres. In fact, many cadres or their relatives have their own business in form of “power sharing”, referring to the free share offer from private entrepreneurs to local cadres as an exchange for political protection.

In addition to personal benefits, local authorities can also earn their gains through guanxi as political actors. The tax revenues generated from the local private sectors were more than 90 percent of total annual revenue of the Wenzhou municipal government. In addition, each year the local governments can receive many donations from private enterprises for public utility and infrastructure construction. They might also enjoy the construction of new office buildings from their business friends (Lin, 1989).

It is this mutual beneficiary bond that sustains and promotes the development of the private economy in Wenzhou. It serves as an adaptive informal institution to challenge the formal rules. In late 1983, Wan Li, deputy premier of the country, visited Wenzhou and witnessed the prosperity of its private economy. He then discussed and affirmed Wenzhou's private economic development. In 1987, Wenzhou was established as an experimental reform zone and was permitted to reform at a deeper level. The government even granted favorable environment for the informal financial system regardless of some infractions (The central government has already banned a number of self-designed financial channels prevalent in Wenzhou,.)

## **Conclusion and Discussion**

Unlike the Western capitalist regimes with highly developed democratic ideology and well-established legal system, China's institutional context is characterized by uncertainty, unpredictability and political sensitivity. Under such a transitional period, institutional actors manifest their interests by using informal adaptive strategies rather than directly confronting the formal rules. However, the informal institutions will not necessarily be informal forever. In most cases, the formal institutional change is tremendously driven by the encroachment and challenge from the informal ones. The case of Wenzhou's private sector development is a persuasive example for this point. Initiated at a local level, Wenzhounese adaptively disguise their ownership status, hire more employees than legally stipulated, and build up independent financing channels. That these strategies can work in practice is largely due to the protection and favor from the local government cadres. The essential mechanism is the operation of guanxi network between the governmental officials and business leaders. On one hand, entrepreneurs rely on political protection to reduce the business risk and overcome formal institutional barriers; on the other, political actors need local economic growth to gain personal benefits and set a good record on their administrative performance. This mutual beneficiary ties compose an informal institution to sustain the local deviance and encroach on formal institutional power. The legal affirmation from the central government and the advocacy of the Wenzhou model give evidence of the transformative force from informal to formal rules.



The success of the Wenzhou Model gives us a sound case to observe the operation of informal institutions and their dynamics with the formal ones. However, given the fact that a large number of financial mechanisms in Wenzhou are still unsanctioned, and a great many migrant workers there are still experiencing illegal exploitation, we still cannot say that to what extent an informal institution can work to change the formal rules, and once changed, if the new established one becomes better or worse. Sometimes entrepreneurs are in an advantaged group for they have the economic resources to help them obtain political protection, despite their weak political status. On the other hand, those peasant workers who have neither economic nor political privilege to exchange in the institutional market are the real people in need of more political and legal protection. How informal institutions are established by those workers, and how powerful their informal institutions can operate against the formal rules are problems worthy of further exploration.

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