

CASE STUDIES IN

CHINA'S INSTITUTIONAL CHANGE

中国制度变迁的  
案例研究

第 1 集

上海人民出版社

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北京天则经济研究所编

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执行主编

张曙光

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# Foreword: Institutional Change and Case Study\*

Zhang Shu-guang

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“Case Study in China’s Institutional Change” is a large scale research project organized by the Unirule Institute of Economics in Beijing. The project will comprise tens of subjects to be completed in consecutive periods and published in separate volumes. The present volume embodies research results of the first phase of the project.

## **I .On China’s Institutional Change**

Since 1978 China has been in the process of institutional reform and social evolution unprecedented in Chinese history which opened a bright future of modernization. The practice of fifteen years shows that a gradual and systematic reform and a rapid stable economic development helped and promoted each other. Such

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\* A part of the contents is provided by Mr. Zhang Yan-shen. The draft of this article was discussed on the Academic Board of Unirule Institute of Economics, and Dr. Zhang Yu-yan and Dr. Sheng Hong raised valuable comments. The author acknowledges their contribution.

an example of development commonly referred to as "Chinese Pattern" has set the foundation of today's situation in China and also provides enormous opportunity of further development in the next century.

The basic characteristics of the institutional change in China is the transition from overwhelming mandatory and planned economy toward market-oriented plural ownership structure. It is not just a marginal adjustment but some fundamental evolution in economic rules and practice. Naturally it involves plenty of complicity and hardship.

First of all, the establishment of an efficient ownership system, the essential of a market economy, is a prerequisite of all reform shifting from a mandatory economy to market economy. In the beginning of China's reform the establishment of new ownership system was not a conscious policy, but spontaneous initiation in this respect helped create a favorable circumstances for further development. The initiation includes: rural reform with re-establishment of farmer's ownership; mushrooming of township enterprises and various non-state-owned firms; quick expanding of joint ventures with foreign capital; development of new cooperative ownership; transaction of property rights; merging and acquisition of enterprises, acceptance of share holding system, and especially, transition of state-owned property rights towards non-state-owned. All these have shaken the root of the traditional economic structure and set a foundation of market system. Clearly defined property rights, a pre-condition for individual exchange, ensure a free choice of transaction based on equal negotiation, and institute

a reliable credit relationship.

Secondly, to establish a market system means to situate the participants, to complete the market mechanism, to impose the market rules. In this regards China has initiated creative measures, however, has also been confronted with challenges. Since the reform started in 1978 the goods market and factors market have remarkably developed. Various specific goods markets, regional markets, unified national market have gradually formed. For example, the foreign exchange market has experienced several stages: the official controlled exchange, opening up of free exchange among business sectors, merging of two markets, now it is proceeding toward convertible currency system. Markets of technologies, of cultural products are rather active. Stock market, treasury bond market, futures market are also in formation. Previously 90 % of goods were under official control, but now most of them are free traded. Formation of market rules is a major goal in the current stage of reform. But owing to lagging of the reform of state-owned enterprises and the governmental function, the market is still under distortion, the fostering of market is resisted, market rules are violated, some non-market performance dies hard.

Thirdly, mandatory economy is substantially a system where the resources allocation is under governmental monopoly. Reform with market orientation is really a self-revolution of government. Government pushes forward the reform process, and at the same time is the target of revolution. Therefore, the change of governmental behavior and function is crucial to the success of the whole

reform. As it showed, government has retreated some of its monopoly power of resource allocation, so made the following changes possible: separation of harbor management from navigation, encouraging competition in small transport business, weakened foreign trade control and implementing trade agent system, permission of trade involvement for large enterprises. At the same time the government strengthened some public service functions, such as to complete the legal system, to protect individual and legal person to conduct normal business, to permit institutional initiation, thus fostered the market and brought it to prosperity. However, on the other side, the government is rigid in some necessary change; superficially it gave up some of its monopoly power but retained it in a hidden form. Such a practice not only distorted the market but also distorted the government, resulting in a double distortion.

Fourthly, in contrary to the mandatory economy which relies on governmental function, market relies on law, rules, and institution. So, market development depends on the establishment of legal system. Nation's legal system can be divided as fundamental and ordinary. The former refers to the constitution and statutes and is difficult to establish; the latter refers to administrative operation, and is relatively easy to establish. China's reform took a special route with least resistance; the major achievements in legal system refer to the ordinary laws. People's Congresses at different levels have set a series of laws, the amount of which are unprecedented in Chinese history, but the completion of fundamental laws lagged behind. For example, the status of enterprises of different

ownerships are not on an equal basis; the freedom of market choice is restricted. The implementation of law seems to be arbitrary; some times it becomes a pretence of legal departments to infringe citizen's rights.

Finally, mandatory economy and market economy belong to entirely different ideologies and different ethics. So the transition of economic institution requires a complete transition of social conscience. The evolution of institution has its own logic beyond any individual's influence. Planned economy is based upon some idea of ideal society and beautiful imagination, but compulsory implementation has been its only means of realization. In such a system individual is but a screw in a machine which is the state, and loses all its originality and creativeness. The basic ethics required in such a system is obedience. In the market system which is a result of continuous development of equal exchange and division of labor, the fundamental logic is free choice and equal status of individuals. The corresponding ethics in market system is mutual respect, mutual benefit, and mutual credit. The ideas of profit, efficiency, equity, rights are being generated and are playing more and more important roles. However, at the same time, corruption, fake products, default of liability, and other ethical deterioration are rapidly dispersed, resulting in a destructive force to the market economy.

In summary, Chinese institutional change is a very profound and fundamental revolution in all aspects of social life. To have an insight understanding of all these changes may help us avoid blind actions and smooth the reform process.



## **II .The Methodology of Case Study**

Case study has been widely adopted in medical, legal, and social studies and has shown its value in finding facts as the very source of theory, but not so popular in economic research, especially in China. Neoclassical economics often ignores facts and process, paying too much attention on mathematical expression and engineering intention, and is ridiculed by Professor Coase as "Blackboard Economics" (1991). The traditional political economics also ignores cases and facts, but occupied by arguments on abstract idea with no assumption and no testing. The separation of facts from theory has put traditional economics into serious crisis. The future of economics in China should make a break through towards a new era. To pay more attention on case study is an important step in this direction.

An economic case is a review and description of an economic event with a clear clue of development and insight analysis. It is an important method to be applied in positive studies.

The fundamental feature of a case study is that the story must be a real one, like a vivid scenario with its exposition, development, outcome and relevant figures or graphs showing the whole factual episode. Economists investigate and analyze various cases, thus hopefully derive valuable interpretation, implication, finding, or even prediction for the socio-economic process taking place in reality. After the story has been read, the reader should be able to grasp the essential points of the case, thus to make his/her own

judgement and derive conclusion. There is no boundary limiting the discussion of the case, since the real world is rich and varied. A case study may or may not lead to a conclusion to verify certain theory, but it has to provide plenty of thoughts to be considered. A good case study leads reader to delve into the general rules behind the story, but not to follow what the author has concluded.

Case study can be classified as four categories as following:

1. Demonstrative case. The case describes the whole process of an economic event. For example, *The Open Economy* by Rudiger Dornbusch describes a specific event in the open process in Argentina, Brazil, Korea, Indonesia.

2. Policy case. The study is policy oriented and serves the policy makers. Since an identical goal can be realized by different approaches which may produce different effects beyond the original expectation, case study is required to test the results of different combination of policies. Most of these studies relate to macroeconomic issues. "Management of American Dollar in 1980s" (1993) by Kester et al. is one of the examples which discusses the governmental intervention on the exchange market and the ensuing debate in the period 1980—1987.

3. Decision case. The study helps the participants in microeconomic activities make a decision. *Cases in International Business Management* (1993) by Zhao Chun-jun collects dozens of cases on international finance, trade, marketing, etc. . Among them the case *Kentucky Fried Chicken in China* describes the decision making process to invest under uncertain conditions. Because of the complexity and uncertainty there is no optimal solution but a

specific solution corresponding to a specific scenario.

4. Discovery and theoretical case. The case proves or disproves a hypothesis by an already happened fact or a case. Such a case study may lead to theoretical advancement. *Organization of Industry and Governmental Regulation* (1989) by Stigler, "Collectivization and China's Agricultural Crisis 1959 — 1961" (1989) by Justin Yifu Lin, "Theory of Grey Market" (1988) by Gang Fan are case studies belonging to this category.

Case study plays an important role in development of economics. Firstly, it serves as a typical example to represent a bunch of similar stories, which may give a common connection between separate events. Secondly, it serves as a test of hypothesis regardless the result is positive or negative. Repeated tests seem to be necessary especially in economic phenomenon. Thirdly, case study may lay a foundation for a hypothesis that can be tested by other scholars or pending to be perfected. In a philosophical point of view, a macroeconomic picture is too complicated to grasp and can be comprehended only with simplification such as the general equilibrium status, but partial equilibrium is easier to realize. Cases are events derived from everyday life and represent some specific points located in the overall picture of the economy. If there is no fact described by case studies to support the hypothesis, economists can hardly enter a clear picture of the economic performance, let alone to develop new theory.

Case study is important also because it provides an idealized experiment, something similar to laboratory experiment in natural sciences. Taking aerodynamics as an example, there are three ways

to examine whether a designed aircraft can fly. The first is to make a real aircraft and try it in the air; the second is to test it by simulation on computer; the third is to test it in wind tunnel. Correspondingly, there are also three ways to reach cognition in economics. The first is learning by doing, or crossing the river by touching the stones. But this is a very expensive way; in most cases the high cost prevents people to do so. The second is through econometric analysis like computer simulation. The third is by case study. There is no wind tunnel in economics, and case study offers an opportunity to project future possibility, like the wind tunnel in aerodynamics.

In fact, learning by doing is not a methodology employed by theoretical economists, but rather a methodology employed by practical economists. Substantially, economics is a science of experience. Although some normative derivation is necessary in economic study, the main tool is positive one. Positive study can be divided into theoretical and empirical; the former is a logic derivation, the latter or empirical also embraces econometrics as well. Econometrics is based on a model which is a general relationship between parameters, and result under general or partial equilibrium described in terms of statistics. However, the real world is too complicated to be expressed by simple equations, especially the variables considered in econometric models are too few. Case study is different; it observes a real story in all respects and facets; it reveals the internal connection and external influencing. The main concern of case study is individuality or particularity, but not generality or common ground. Case study may also bring alien knowl-

edge into local context. As long as there are abundant information in case study, it always carries new consciousness. Indeed, cases do not have any statistical meaning, so it can not infer any general rule from induction.

Case study may lead to discovery of new idea or hypothesis, but it has to be verified by more evidences. It does not matter if case contains contradictory points, since logical deduction is not the main stem of a case. In Chinese classics there are many sages spelling out a truth by telling a story. These are excellent examples of case study. In short, all scientific truth are originated from specific observation, and case study provides a foundation of further analysis. Through case studies, from individuality to generality and vice versa, we may gradually approach the truth.

### **II. The Case Study on Chinese Institutional Change**

The issues mentioned in I all are interesting to institutional economists and will be covered by the planned study. We proceed step by step according to the resources available. In 1993 when we designed the program dozens of topics were listed and categorized as market, firm, social management, legal, and ethical institutions (refer to Appendix 2). Along with the development of Chinese reform, institutional origination have been emerging, so new topics have been added. For example, new structure of firms with unique ownership relationship is happening which can not be classified as any of the known typical ones. Some of them even do not have a clearly defined ownership, especially, how to measure and define

the original capital, who owns the accumulated profits. But they have their own efficiency merits in firm performance and have provoked some new idea for further reform of firm ownership structure. Acquisition and merging under the institutional, legal, and political constraints are developing not only between firms but also between various kinds of capital holdings, some of them involve the participation of local government, foreign partners, private and public sectors. All these flexible rearrangements become a unique phenomenon in Chinese economic transition period. Another development is the emerging of non-governmental organization with different purposes, resources compositions, and functions. They replace some of the governmental functions, break the monology of governmental administration and check and balance the power of government. All these events become the targets of our study.

China's reform towards market system is a gradual process, so there have appeared a series of intermediate forms of institution. These institutional arrangements are different from any known typical ones, and can not be explained by any standard theory, but are important in terms of institutional transition and valuable for academic research. They serve as a bridge across the gap from the current institution to a better institution. These intermediate institutional arrangements are very rare in human history. Quantitative methods can hardly be adopted in the research of such arrangements, while case study proves a much better approach. Intermediate institutional arrangements are not stable; they may change towards more advanced pattern or retreat back to

the original arrangement, depending on the circumstances. Case study will record all the relevant events and find out the connections among them. Equilibrium and disequilibrium, steady and transient are particularities of institutional change and deserve the attention of researchers. Because of the unstable character of intermediate arrangements, actors on the arena may be directed by short term benefit and result in further unstable expectation. This character must be focused by a case study. Transitional arrangements bear the nature of both the old institution and the new one and are a wise mixture of those two, which can avoid high cost of transformation caused by the institutional constraints. Institutional changes happen just because the new arrangement can reap more benefit than the old one for all participants. Benefit is the driving force of all institutional changes. Case study for institutional change should note the internal structure of different arrangements, the relative position of old and new institutional elements and their trend of change. A good case study focusing on the transient arrangement will help us have a better understanding of institutional change in China and perfect the institutional economics.

Institutional change is a spontaneous process driven by disequilibrium forces. To facilitate analysis, the intermediate states can be treated as a series of equilibrium states, so technique of equilibrium analysis is also useful in case study. Both continuity of old institution or implantation of new institution, all are results of interaction of individuals who pursue his/her own interest. Even in the case that government imposes a new institution, it is also a result

of compromising interests of all respects, including interests of government and the whole society. Acceptance or rejection of an imposed institution also depends on interest considerations. Therefore, institutional arrangements are consequences of social game, or the result of many individual's performance, and can not be changed by any single individual's subjective intention. Based upon such an understanding, case study has to delve into each individual's motivation that may lead to new theory in institutional economics. A hypothesis can be derived from the establishment of new firms and group of corporate, that firms established by state are the foundation of planned economy; while firms owned by state firms not directly by the state can be a vehicle for transforming towards market economy. Rules not written on documents may be the common acknowledged silent constitution. Again, successful performance of some new firms, both state owned and privately owned, with new arrangement on property rights, may imply that under a given arrangement of property rights, consideration on transaction cost is more important than the consideration on property rights; and further more, changes in rules of transaction happen along with the changes in arrangement of property rights.

Therefore, case study should proceed along the following thoughts(Justin Y. F. Lin, 1995):

1. Observation of institution is a must, especially how and where the disequilibrium of institution happens, or what kind of opportunity of profit making begins to appear.
2. What kind of institutional change can catch the profit that



could be shared among participants. Who will push the institutional change, how much is the profit and how much is the cost, and how profit and cost are shared among participants. What are the constraints of institutional change.

3. How incentive mechanism changes after such institutional change. How it affects the allocation of resources and the economic efficiency.

4. What is the relationship of a specific institutional change with the overall institution structure. How specific institutional change impacts the other institutional arrangements.

Case study may direct to one of the preceding specific topics or a combining analysis of all these topics.

#### **IV. Summary of the Case Studies**

There are nine case studies in this volume which can be classified as three of financial issues, two of governmental budget, two of business and sector performance, and two of rural problems. The purpose of the current case study is to answer the following questions through empirical study: What institutional change are happening in China? How did they happen? What will be the future of these changes? Can existing theory be used to explain these changes? Could new theory be established and how can it be established? What inference can be derived from Chinese experiences in institutional changes for other countries? Each case study answers these questions but with different focus. Some features of these studies can be summarized as following: