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The Power of Informal Institutions

> We must severely attack all actions in the financial arena that are illegal or in violation of regulations. We must guarantee that financial laws, regulations, and rules are implemented thoroughly. We must emphasize the prohibitions against banks using high interest rates to monopolize deposits, illegal fund-raising in society, and haphazard financial activities.
>
> —*Renmin ribao* (People's Daily), February 1, 1999

As financial turmoil swept through Asia in the late 1990s, Beijing stoically announced that China would not devalue its currency. It would act as a responsible member of the international economy and weather the storm. Sure enough, the *renminbi* retained its value, and macroeconomic indicators reveal that the Chinese economy emerged relatively unscathed from the regional financial crisis.

Over the last two decades of the twentieth century, however, symptoms of domestic financial malaise were in fact accumulating at the local level. A vast underworld of informal financial intermediaries emerged in the wake of economic liberalization. Moreover, official efforts to clamp down on illegal financial practices and institutions had the perverse effect of triggering public expressions of discontent.[1] Consider the following incidents:

- November 1998, Zhengzhou, Henan: Over two thousand people stage a demonstration in the provincial capital after their savings are lost in a failed investment firm.

1. In July 1998 the State Council issued formal "Provisions on the Cancellation of Illegal Financial Institutions and Activities," which stipulated (rather repetitively) that illegal financial institutions should be banned. See "Procedures for Banning Illegal Financial Institutions and Illegal Financial Business Activities," *Xinhua News Agency*, July 22, 1998, reported in FBIS-CHI-98-209.

- September 1999, suburbs of Changsha, Hunan: Some fifty demonstrations involving five thousand farmers are staged to protest the closure of two thousand branches of rural credit and savings foundations.
- November 1999, Chongqing: Three hundred protesters waving large portraits of Chairman Mao demonstrate against corruption after the collapse of a local investment firm.

This modest sampling of local crises reveals the dark, destabilizing side of informal finance in contemporary China. This is the side that makes conservatives in Beijing worry that the first two decades of economic reform proceeded too fast, that makes the party-state feel out of control. Private financial transactions can sabotage state efforts at controlling inflation, foster speculative capital investments, and, at the feared extreme, undermine the political legitimacy of the regime.

At the same time, it is apparent that informal finance has also played a productive developmental role in the economy. The private sector has clearly been the most vibrant part of China's economy since the initiation of economic reform in 1978. More than thirty million private businesses were established in the next two decades, but official state banks chiefly extend credit to state and collective enterprises, not private ones. As of the end of 2000, *less than 1 percent* of loans from the entire national banking system had gone to the private sector.[2] Business owners take their exclusion from formal sources of credit for granted.

When I surveyed private entrepreneurs, the question "Have you ever borrowed money from a bank?" typically elicited animated, if not condescending, responses. For example:

"Are you crazy? Private entrepreneurs can't get loans from banks!"

"I'm not literate, I have no collateral, and I'm not even registered as an urban resident in this city. Would *you* lend me money?"

And a favorite from a restaurant owner who laughed in my face:

"A state bank wouldn't give me a loan if Chairman Mao himself rose from the dead and told them to give me one!"

Such responses demand an answer to the question: How could an entire economic sector develop and flourish without access to the state-dominated banking system? If banks are not lending to private entrepreneurs, then how has China's "economic miracle" been financed?

The short answer: informal, and often illegal, finance. Private entrepreneurs rely on a cornucopia of informal financing practices. These range from casual interpersonal borrowing and trade credit among wholesalers

2. Calculated from Table 19.3 of the *Zhongguo tongji nianjian 2000* (China Statistical Yearbook).

and retailers to more institutionalized mechanisms such as rotating credit associations, grassroots credit cooperatives, and even full-service yet unsanctioned private banks. The sheer variety of informal financing options used by entrepreneurs is impressive and worthy of documentation for an empirical understanding of private-sector finance in reform-era China. Indeed, a study of such a central component of China's political economy is much needed. Western scholars have focused on the more salient dimensions of the economic reform process, and Chinese publications barely acknowledge informal finance. It is like the unattractive grease in the wheels of the transitional economy—necessary for movement, but no one really wants to call attention to it. Yet behind the precarious balance sheets of state banks and national statistics showing private-sector growth, everyday people are operating at the margins of legality. Millions of individuals have begged, borrowed, and stolen to create new businesses, new lives, and new challenges for the regime. Drawing on twenty-three months of fieldwork between 1994 and 2001, this book sheds light on how the deftly disguised world of informal finance has contributed to China's private-sector development since the late 1970s.

This book also shows that the dynamics of informal finance have implications for our understanding of China's contemporary political economy and, more broadly, the way we think about economic and institutional development. Informal finance is embedded in a larger untold story about private-sector growth in the absence of a developed system of property rights. Not only are China's business owners excluded from state banks, but their economic exchanges are only weakly protected by the rule of law, and in many cases their private financial transactions are technically illegal. These operational realities challenge conventional notions about the necessary conditions for economic growth. Economists associated with the influential property rights tradition of Douglass North, for example, might wonder why anyone would want to participate in China's transitional economy.[3] Scholars take for granted that the prosperity generated by Western capitalism rests on a clearly defined body of laws regulating the ownership, use, and transfer of assets. When consistently enforced, according to this view, property rights reduce the uncertainty and transaction costs of market exchanges, and provide economic actors with the information

3. James M. Buchanan, *Property as a Guarantor of Liberty* (Aldershot: Edward Elgar, 1993); Harold Demsetz, "Towards a Theory of Property Rights," *American Economic Review* 57, 2 (1967): 347–59; Douglass North and Robert P. Thomas, *The Rise of the Western World: A New Economic History* (New York: Cambridge University Press, 1976); Douglass North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *Journal of Economic History* 49, 4 (1989): 803–32; and Douglass North, *Institutions, Institutional Change, and Economic Performance* (New York: Cambridge University Press, 1990).

and incentives to maximize efficiency.[4] Consequently, some explain the persistence of Third World underdevelopment by its lack of formal property rights. Hernando de Soto, for example, argues that if the poor were legally permitted to accumulate, exhibit, and trade their informal wealth, they would be much richer.[5] In China, however, there *has* been a dramatic expansion of private economic activity. Financial entrepreneurs, private businesses, and discriminating consumers are accumulating, exhibiting, and trading their assets, both formal and informal. That this is occurring despite the nebulous nature of private property rights presents a challenge to conventional theories of capitalist growth.

The property rights perspective provides incomplete insight into China's transitional economy because its assumptions of economic rationality oversimplify the political and social context of real-life interactions. Instead of focusing on lack of transparency in property rights, this book explains how and why the private sector has flourished in certain parts of the country under apparently uncertain and risky circumstances. I do not dismiss the utility of developed property rights; I do suggest, however, that their causal logic should be redefined and tailored to China's actual conditions.[6] Within what has been called the ambiguous and vaguely defined character of property rights in China, political and economic actors have been able to devise mutually comprehensible agreements regarding the use and control of various assets.[7] Sometimes these agreements are explicitly contractual and become legally binding, as in the case of thirty-year leases for land-user rights. At other times, economic agreements represent bargained outcomes between local officials; preferential tax treatment for local collective enterprises is a common example. And in many forms of informal finance, the institutional arrangements reflect self-enforcing innovations by ordinary people who are unlikely to seek legal enforcement of their activities

4. Ronald H. Coase, "The Nature of the Firm," *Economica*, November 1937, 386–405; Coase, "Social Costs," *Journal of Law and Economics* 3 (October 1960): 1–44; Yoram Barzel, *Economic Analysis of Property Rights* (Cambridge: Cambridge University Press, 1989).

5. Hernando de Soto, *The Mysteries of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000). Cf. Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000).

6. A volume that does just that is Jean C. Oi and Andrew G. Walder, eds., *Property Rights and Economic Reform in China* (Stanford, Calif.: Stanford University Press, 1999). Cf. Hu Xiaobo, *Problems in China's Transitional Economy: Property Rights and Transitional Models, East Asian Institute Occasional Paper* no. 6 (Singapore: World Scientific/Singapore University Press, 1998).

7. David D. Li, "A Theory of Ambiguous Property Rights in Transition Economies: The Case of the Chinese Non-State Sector," *Journal of Comparative Economics* 23, 1 (1996): 1–19; Victor Nee and Sijin Su, "Local Corporatism and Informal Privatization in China's Market Transition," in Thomas Lyons and Victor Nee, eds., *The Economic Transformation of South China: Reform and Development in the Post-Mao Era* (Ithaca: Cornell University East Asia Program, 1994); Martin Weitzman and Chenggang Xu, "Chinese Township-Village Enterprises as Vaguely Defined Cooperatives," *Journal of Comparative Economics* 18 (1994): 121–45.

because they are illegal in the first place. Ultimately, there is a vast gray area between ideal-typical property rights–observing economies and impoverished countries with imperfect legal systems, and much of East and Southeast Asia's growth falls into that category. Informal finance is a vital yet typically neglected part of the story.

In order to specify the actual workings of informal finance in China, this book is structured around three thematic questions: (1). *The popularity of informal finance despite its illegality*: Given that the central government forbids private financial institutions, how have entrepreneurs managed to create unofficial alternatives to state banks? (2). *Local variation in informal finance*: Given that private entrepreneurs all over China share the structural condition of restricted access to formal bank credit, why do some localities harbor a colorful range of informal financial intermediaries, while other localities have barely any at all? (3). *Variation in private entrepreneurs' use of informal finance*: Why do entrepreneurs with similar capital constraints, operating in the same area, employ vastly different types of financing strategies? The following chapters provide rich empirical answers to these questions, but the questions themselves have important analytical implications.

First, the disjuncture between official state regulations and the popularity of informal finance suggests that the financial capacity of the state in China is not as strong as one might expect, given its authoritarian mode of governance. Informal finance is thriving, and official funds are leaking out of the state banking system despite the potentially extreme penal consequences.

Second, the variation in the local supply of private finance challenges the notion that similar macro-level economic constraints will yield similar solutions. Even though the private sector as a whole shares limited access to the formal financial system, the actual expression of informal finance varies widely across localities. Instead of institutional isomorphism, there is remarkable institutional diversity.[8] Some localities have a limited range of informal financial institutions, while others have a myriad of private credit facilities. I attribute this variation to local governments' orientation toward private businesses and, hence, their degree of tolerance for the unusual institutional camouflage that private financial intermediaries often have to wear.

8. One branch of organizational theory expects institutions to become more similar to one another as a result of competitive and adaptive pressures. See Marco Orrù, Nicole Woolsey Biggart, and Gary H. Hamilton, "Organizational Isomorphism in East Asia," in Walter W. Powell and Paul J. DiMaggio, eds., *The New Institutionalism in Organizational Analysis* (Chicago: University of Chicago Press, 1991), 361–62. This argument is also made in Paul J. DiMaggio and Walter W. Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields," *American Sociological Review* 48 (April 1983): 147–60.

Third, the variation in entrepreneurs' choice of financing practices derives from the micro-logic of institutional choice and market segmentation at the grassroots level. Two business owners operating at the same scale, in the same locality, may use completely different types of informal finance because they draw on different social networks and political resources. Although some forms of informal finance rely primarily on economic selection criteria and enforcement mechanisms (e.g., business performance and the use of collateral and interest rates), most informal credit arrangements also involve a combination of social pressure, goodwill, and trust among the participants. In other words, the noneconomic characteristics of entrepreneurs matter in the world of informal finance.

In exploring these three issues, this book demonstrates that informal micro-level interactions have macro-level consequences—and, relatedly, considers why the state has repeatedly attempted to eliminate something that is actually essential to the economy. Institutional development is not merely a top-down process, neatly reproducing the official mandates of the center. Political and economic realities at the local level distort the implementation of national policies.[9] The assumed market logic of financial transactions is actually mediated by a political and social logic. The creation and use of private finance are not purely market-driven, even when they occur beyond the scope of the state.

The Political Production of Informal Finance

The overarching question of this book concerns the paradox of institutional creation in a politically and financially repressive environment. How are entrepreneurs even able to create unofficial alternatives to state banks when the central government explicitly forbids private financial institutions? The People's Republic of China (PRC) remains an authoritarian, Communist party-state that monopolizes not only the legitimate use of force in the Weberian sense but also the legitimate distribution of capital in the economy. Powerful nationalistic and ideological reasons were articulated during the Mao era for public ownership and allocation of capital. Before the socialist state withered away, it had to defend its borders from "imperialist invaders" and expunge the "capitalist bourgeoisie" from within. Although this ideological imperative has now faded, concerns for maintaining macroeconomic (and therefore political) stability have

9. Joel S. Migdal, Atul Kohli, and Vivienne Shue, eds., *State Power and Social Forces: Domination and Transformation in the Third World* (New York: Cambridge University Press, 1994); Kevin O'Brien and Lianjiang Li, "Selective Policy Implementation in Rural China," *Comparative Politics* 31, 2 (1999): 167–86.

rendered monetary control no less pressing. The party-state still dominates the financial system and still deploys ideological rhetoric at times to justify this domination. Yet finance capitalists systematically eliminated by the Communist revolution—either through domestic persecution or by being driven abroad to Hong Kong, Taiwan, and other parts of Southeast Asia—have reappeared. After a four-decade hiatus the back-alley loan sharks, pawnbrokers, and professional financiers are back in business; furthermore, additional players are offering new and creative financial services. How is this possible?

Neoclassical economists might suggest that the emergence of informal finance is a natural product of market mechanisms. The elementary laws of supply and demand expect alternative sources of finance to appear as long as the official supply of credit falls short of actual market demand for credit. Because official state banks are institutionally biased toward extending soft loans to state-owned enterprises, they are unable to meet the financing needs of private businesses. Thus, most economists would not be surprised to find that profit-motivated entrepreneurs have risen to tap a structurally available market. As one factory manager turned loanshark put it, "The state factory doesn't really need me, but the local entrepreneurs do. Lending money is a better use of my talents, time—and money." Informal finance, or what economists call the "curb market," is a universal phenomenon. Even advanced industrialized countries harbor substantial pockets of curb market activity to serve those excluded from the formal financial system for reasons of credit history, gender, ethnicity, and legal status. This economic explanation makes intuitive sense, and its theoretical parsimony helps explain the existence of informal finance during China's reform era. It remains unclear, however, how curb market operators are able to flourish under the glare of the party-state. In other words, the intellectual progeny of Adam Smith can account quite well for the demand for additional finance in the economy, but their determinist logic fails to explain the ability of ordinary economic actors to supply private-sector finance. Why did the state not crush China's flourishing informal markets?

Politics is the largest chunk of the puzzle missing from the free-market economic paradigm, because capital markets are not in fact free in China, or in most other parts of the world for that matter. Karl Polanyi and many other scholars have observed the irony that the most liberalized economies entail extensive intervention by a regulatory state.[10] The United States and Britain represent archetypal historical examples of this phenomenon. A

10. Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944). Cf. Steven K. Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Ithaca: Cornell University Press, 1996).

liberalized financial system requires the highly visible hand of the state to hold the invisible hand of the market. The mature capitalist state preserves a competitive market environment and ensures the reliability of profit-oriented transactions by serving as the ultimate third-party enforcer of contractual exchanges, deploying punitive recourse when property rights are violated. The party-state in China has not reached the point of holding the legal door open for private financial institutions or permitting regulated competition within the financial sector—and, I would argue, one should not assume that it will inevitably converge upon the U.S. or British model of the liberal regulatory state.[11] Nonetheless, over the course of reform, the party-state has established increasingly specialized agencies to govern financial institutions. Liberalization and monetization of the economy have been accompanied by heightened efforts to standardize the management of state-sanctioned financial intermediaries, commercialize their lending procedures, and reform or close down noncompliant operations. In this sense, China's reform era could be depicted as a period of regulatory state-building, which suggests restricting the space for informal financial transactions and moving toward a more corporate and politically neutral commercial banking system.[12]

Political realities complicate this theoretical ideal type of the regulatory state, however. In particular, even though the banking system has gone through commercializing reforms, state banks continue to engage in "policy lending" to state-owned enterprises (SOEs) in industries targeted by the center as development priorities. In contrast to commercial loans, policy loans are extended on the basis not of creditworthiness but rather, of political considerations. When asked about the large portion of policy loans in their lending portfolios, state bank managers instinctually respond, "It is our patriotic duty to support pillar industries." When pressed about the definition of "pillar industries," however, most credit officers will concede that authorities pressure banks to subsidize politically important enterprises. Because these interventionist policies have occurred in tandem with rapid growth rates, some political scientists have cited China as yet another example of a successful developmental state in East

11. Although China's membership in the World Trade Organization includes a commitment to full liberalization of foreign bank franchises over a transitional five-year period, the extent of interest-rate liberalization and the relative autonomy of domestic banks to deal in foreign currencies remain to be seen.

12. The rationale for this argument is that new forms of economic interaction have inspired regulatory interventions by the state. Victor Nee, "Peasant Entrepreneurship and the Politics of Regulation in China," in Victor Nee and David Stark, eds., *Remaking the Economic Institutions of Socialism: China and Eastern Europe* (Stanford, Calif.: Stanford University Press, 1989). Cf. Vivienne Shue, "State Sprawl: The Regulatory State and Social Life in a Small Chinese City," in Deborah Davis, Richard Kraus, Barry Naughton, and Elizabeth Perry, eds., *Urban Spaces and Contemporary China* (New York: Cambridge University Press, 1995).

Asia, joining the ranks of South Korea, Taiwan, Singapore, and Hong Kong.[13]

The basic notion of the developmental state implies that the authoritarian center in Beijing ("the state") has demonstrated relative autonomy from "society." In China's case, society may be broadly construed as comprising all particularistic interests falling outside the innermost core of the central state's leadership and bureaucracy.[14] This would arguably include a panoply of organized interests that actually receive public sponsorship, such as mass associations, social organizations, and even parts of local governments.[15] According to state-centric perspectives, a key expression of the state's relative autonomy from society is its ability to formulate developmental policies that promote the overarching interests of the national economy, not just those of an important locality or interest group.[16] And an integral component of industrial policy in developmental states is the allocation of credit toward *nationally defined* strategic economic sectors, not the ones that lobby the hardest.[17] As Alexander Gerschenkron contended, in late industrializing countries the state may need to take on

13. See Gordon White, ed., *Developmental States in East Asia* (New York: St. Martin's Press, 1988). Cf. Marc Blecher, "Developmental State, Entrepreneurial State: The Political Economy of Socialist Reform in Xinji Municipality and Guanghan County," in Gordon White, ed., *The Chinese State in the Era of Economic Reform* (Armonk, N.Y.: M. E. Sharpe, 1991); and Ming Xia, *The Dual Developmental State* (Brookfield, Vt.: Ashgate, 2000).

14. In this context, "society" refers to organized interests that deviate from a relatively autonomous state—not only civil society, which connotes social groups, processes, and movements that are nongovernmental in character. For a thoughtful debate that distinguishes between civil society and the Habermasian notion of the public sphere, see the special symposium, "'Public Sphere'/'Civil Society' in China?" *Modern China*, 1993.

15. This is typical of state corporatist systems. As applied to China, see Yijiang Ding, "Corporatism and Civil Society in China: An Overview of the Debate in Recent Years," *China Information* 12, 4 (1998): 44–67; Jonathan Unger and Anita Chan, "Corporatism in China: A Developmental State in an East Asian Context," in Barrett McCormick and Jonathan Unger, eds., *China after Socialism: In the Footsteps of Eastern Europe or East Asia?* (Armonk, N.Y.: M. E. Sharpe, 1996), 95–126; Kenneth W. Foster, "Associations in the Embrace of an Authoritarian State: State Domination of Society?" *Studies in Comparative International Development* 35, 4 (2001); Vivienne Shue, "State Power and Social Organization in China," in Migdal, Kohli, and Shue, eds., *State Power and Social Forces*, 65–88; and Gordon White, Jude Howell, and Shang Xiaoyuan, *In Search of Civil Society: Market Reform and Social Change in Contemporary China* (Oxford: Clarendon, 1996). On "social organizations" (*shehui tuanti*), see Tony Saich, "Negotiating the State: The Development of Social Organizations in China," *China Quarterly* 161 (March 2000): 124–41.

16. For the now classic articulation of this approach, see Theda Skocpol, "Bringing the State Back In: Strategies of Analysis in Current Research," in Peter Evans, Dietrich Reuschemeyer, and Theda Skocpol, eds., *Bringing the State Back In* (New York: Cambridge University Press, 1985), 3–37.

17. A vast literature has emerged since Chalmers Johnson's *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford, Calif.: Stanford University Press, 1982). For a thoughtful evaluation of the developmental state research agenda, see Meredith Woo-Cumings, ed., *The Developmental State* (Ithaca: Cornell University Press, 1999).

the role of the financial entrepreneur by making potentially risky investments that ordinary economic actors would eschew for lack of resources or entrepreneurial verve.[18] Hence, the German state developed a universal banking system to finance heavy industrialization during the late nineteenth century, and the Japanese state created banks to develop a military-industrial complex during the Meiji period.[19] During China's reform era the party-state has similarly established or resuscitated its share of industry-specific banks in an effort to catch up with more advanced industrialized countries. From this point of view, the socialist state of the Mao era has become more a capitalist developmental state.[20]

The comparative insights of statist perspectives help explain the party-state's regulatory and developmental roles in China's transitional economy. In particular, they reinforce the state's presiding role in the formal financial system—coming one step closer to filling the political gap left by the neoclassical framework. But the original question remains unanswered. China's party-state appears to be sufficiently autonomous from society to reshape the banking system.[21] Yet the vast majority of private financing mechanisms reside beyond the scope of permissible economic activity. Private entrepreneurs are violating official laws and regulations to finance their businesses. They are banking creatively behind the legal lens of the state.

Furthermore, that entrepreneurs are actually banking behind different bureaucratic parts of the state in different localities leads to the second question of the book: Why does tremendous variation exist in the scope and scale of informal finance throughout the country? Some areas have a wide variety of private financing mechanisms, which compete with one another and even with some formal financial institutions. Other areas, by contrast, are nearly devoid of private financial mechanisms. Again, economists would speculate that informal finance is flourishing in localities where the private sector is a central part of the economy, whereas places

18. Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, Mass.: Harvard University Press, 1962).

19. Additional modes of financial intermediation in capitalist economies are discussed in John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Oxford: Martin Robertson, 1983).

20. Gordon White, *Riding the Tiger: The Politics of Economic Reform in Post-Mao China* (London: Macmillan, 1994).

21. Kaja Sehrt, "Banks versus Budgets: Credit Allocation in the People's Republic of China, 1984–1997" (Ph.D. diss., University of Michigan, 1998). Yasheng Huang makes the broader argument that the center retains considerable authority over the localities as evidenced by the implementation of macroeconomic stabilization measures that are not necessarily in the interest of the fastest growing provinces. Yasheng Huang, *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era* (New York: Cambridge University Press, 1996).

with a smaller private sector would not be expected to have much of a curb market because the demand for credit would be correspondingly limited. But the evidence suggests otherwise: localities with comparable economic structures and, presumably, comparable levels of demand for private finance exhibit dramatic variation in curb market activity.

A more nuanced application of the state-centric framework might question the uniformity of the central state's financial capacity in various localities. If entrepreneurs are evading financial regulations to varying degrees, then perhaps the growing regulatory state in Beijing does not exercise financial authority consistently in all parts of the country.[22] As a matter of fact, "the state" has not allocated credit to private enterprises in the systematic manner that one would expect in a "developmental state." Although China's central party-state performs key regulatory and developmental functions, the uneven occurrence of informal finance suggests that central banking regulations are not being enforced consistently across localities.

Breaking Down the Conventional State-Society Dichotomy

Rather than viewing the endurance of informal finance as a mere function of market demand, one must consider the political circumstances supporting its emergence and survival. Specifically, one must disaggregate the party-state's administrative capacity in order to explain variation in informal finance across China's different regions. Although the People's Republic of China is technically a unitary rather than a federal system, the party-state actually consists of multiple levels of government and Communist Party branches at the national, provincial, city or county, and township levels. At the same time, the "state" (or "government") also consists of functional bureaucracies duplicated at each of those administrative levels. Recognizing the organizational reality of these cross-cutting governmental structures is the first step in explaining China's empirical paradoxes.[23]

Indeed, the most insightful studies of China's reform-era political

22. I would not go so far as to suggest, however, that geographical and administrative fragmentation poses a serious risk of Soviet-style collapse. Concern about this risk is expressed in Wang Shaoguang and Hu Angang, *Report on the State of the Nation: Strengthening the Leading Role of the Central Government during the Transition to the Market Economy* (New Haven: Yale University Press, 1993), also published as *Zhongguo guojia nengli baogao* (Hong Kong: Oxford University Press, 1994). The authors toned down this position, however, in *The Political Economy of Uneven Development: The Case of China* (Armonk, N.Y.: M. E. Sharpe, 1999), 202.

23. Kenneth Lieberthal, "The 'Fragmented Authoritarianism' Model and Its Limitations," in Kenneth Lieberthal and David M. Lampton, eds., *Bureaucracy, Politics, and Decisionmaking* (Berkeley: University of California Press, 1992), 1–30.

economy have been those that systematically disaggregated the multiple and often competing levels and branches of government. They have looked beyond the battles of elite politics in Beijing to the politics of economic development at the subnational level.[24] Different provinces, counties or cities, townships, and even villages have pursued policies that led to outcomes not originally anticipated by the center. The decollectivization of agriculture, rural industrialization based on Township and Village Enterprises (TVEs), the influx of foreign investment, and the de facto privatization of state and collective enterprises have all contributed to China's macroeconomic growth (and, at times, instability)—and the key message is that these developmental processes may be attributed to the selective interpretation, if not outright violation, of central policies by local governments.[25]

Meanwhile, the corporate attempt by particular state bureaucracies to carry out their duties has also been credited with contributing to national growth.[26] Given that most if not all of the vertically organized governmental agencies face budgetary constraints, it is in their economic interest to pursue policies that enhance their material resources. Even bureaucracies in noneconomic sectors such as research institutes and the People's Liberation Army have engaged in explicitly for-profit business ventures.[27] Therefore, China could be considered an "entrepreneurial state" because bureaucratic branches of the state are increasingly involved in running for-profit businesses.[28] Although the increasing involvement of local governments and individual bureaucracies in local commerce has certainly occurred in tandem with economic growth, I would argue that one cannot automatically equate their economic pursuits with positive developmental

24. Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk, N.Y.: M. E. Sharpe, 1994); Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993); and Jonathan Unger, ed., *The Nature of Chinese Politics, from Mao to Jiang* (Armonk, N.Y.: M. E. Sharpe, 2002) focus on elite politics.

25. Marc J. Blecher and Vivienne Shue, *Tethered Deer: Government and Economy in a Chinese County* (Stanford, Calif.: Stanford University Press, 1996); Peter T. Y. Cheung, Jae Ho Chung, and Zhimin Lin, eds., *Provincial Strategies of Economic Reform in Post-Mao China: Leadership, Politics, and Implementation* (Armonk, N.Y.: M. E. Sharpe, 1998); Jean C. Oi, "Fiscal Reform and the Economic Foundations of Local State Corporatism in China," *World Politics* 45, 1 (1992): 99–126; Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley: University of California Press, 1999); Kristen Parris, "Local Initiative and National Reform: The Wenzhou Model of Development," *China Quarterly* 134 (June 1993): 242–63; Ezra F. Vogel, *One Step Ahead in China: Guangdong under Reform* (Cambridge: Harvard University Press, 1989); and Lynn T. White III, *Unstately Power*, vol. 1, *Local Causes of China's Economic Reforms* (Armonk, N.Y.: M. E. Sharpe, 1998).

26. Blecher, "Developmental State," 265–91; and Jane Duckett, *The Entrepreneurial State in China: Real Estate and Commerce Departments in Reform Era Tianjin* (London: Routledge, 1998).

27. James Mulvenon, *Soldiers of Fortune: The Rise and Fall of the Chinese Military-Business Complex, 1978–98* (Armonk, N.Y.: M. E. Sharpe, 2001).

28. Blecher, "Developmental State"; Duckett, *Entrepreneurial State*.

outcomes. Commercial and extractive activities that are justified as contributing to budgetary (and extrabudgetary) revenue may in fact be more like predatory rent-seeking. Indeed, the rise in rural unrest over excessive fees and levies and anticorruption campaigns points to the less appealing side of economic liberalization.[29]

In short, by viewing "the state" in its administrative and bureaucratic subcomponents, earlier studies of China's reform-era political economy have exposed a contextually contingent matrix of incentives which has inspired a mix of developmental, entrepreneurial, and predatory behavior at the subnational level. Building on these insights, this book digs below the analytic lens of a purely state-centric approach to expose the intentionally shrouded workings of informal finance. For an understanding of how informal finance has contributed to China's economic growth—and also to sporadic episodes of instability—it is necessary to examine the multiple layers of institutional interests, both complementary and competing.

Furthermore, just as breaking down the state is important for revealing the variety of vertical and horizontal governmental actors, transcending the definitional boundaries of the "society" half of the conventional state-society divide is also essential for unveiling informal finance. Analyses of state-society relations typically exclude actors whose interests are not sufficiently concentrated or organized to be a recognizable component of society in the way that most political scientists conceptualize it. Moonlighters, peddlers, and loan sharks would all fall into this extrasocietal category. The problem with excluding these apparently marginal actors, however, is that they may simply go ahead and evade banking regulations at the ground level, even if they do not formally lobby the party-state for financial liberalization.[30] Curb market operators generally maintain a low profile to avoid unpleasant political attention. As a result, the elusiveness of their activities also presents challenges for conventional research methodologies. To my knowledge, the state does not possess a list of all the private banks or finance companies in China. They are illegal, so they cannot be officially registered as for-profit financial intermediaries. They operate beyond conventional notions of state and society. Therefore, in

29. Thomas P. Bernstein, "Farmer Discontent and Regime Responses," in Merle Goldman and Roderick MacFarquar, eds., *The Paradox of Post-Mao Reforms* (Cambridge: Harvard Contemporary China Series, Harvard University Press, 1999), 197–219; Thomas P. Bernstein and Xiaobo Lü, *Taxation without Representation in Contemporary China* (New York: Cambridge University Press, 2003); Xiaobo Lü, "Booty Socialism, Bureau-preneurs, and the State in Transition: Organizational Corruption in China," *Comparative Politics* 32, 3 (2000): 273–94.

30. In the context of agricultural decollectivization and evasion of population control policies, Kate Xiao Zhou has referred to similar grassroots phenomena as the "unorganized power of the peasants" in *How the Farmers Changed China: Power of the People* (Boulder, Colo.: Westview Press, 1996). Cf. Daniel Kelliher, *Peasant Power in China: The Era of Rural Reform, 1979–1988* (New Haven: Yale University Press, 1992).

addition to conducting a survey of private entrepreneurs, the second component of my fieldwork entailed interviews with managers of state and nonstate financial institutions, officials from various agencies, and academics with the relevant expertise.

Learning from Grassroots Actors

I found that the entrepreneurs themselves offered the most valuable insights into the puzzling persistence of illegal financial activity and the political economic differences among localities. Recall, for example, the restaurant shop owner who exclaimed that she could not get a loan from a state bank even if the embalmed Chairman Mao made the request on her behalf. Her comment identified one of the most basic challenges facing financial reformers in Beijing. Even the paramount leader of China could not single-handedly command commercialization of the banking system. The Ministry of Finance has tried. The State Council has tried by separating the central bank, the People's Bank of China, from the Ministry of Finance. And then the People's Bank of China itself has tried. State banks literally cannot afford to carry any more nonperforming loans; meanwhile, everyone knows that private enterprises face capital constraints. Even the *People's Daily* has critically noted the inefficiency of this situation numerous times. Yet state banks continue granting soft loans to state enterprises rather than to profit-making operations. Why?

Survey data, official statistics, and the voices of business owners, bank managers, financial entrepreneurs, and cadres demonstrate how the local political economy fundamentally mediates the way in which national policies and regulations are implemented at the grassroots level. The scope and scale of informal finance relies on what I call the *local logics of economic possibility.* Specifically, the orientation of the local government toward the private sector plays a key role in explaining the contours of informal finance in any particular locality. To simplify a bit, some local governments have been very supportive of private-sector development since the earliest years of reform; they have gone out of their way to provide more favorable conditions for private businesses. In other localities, however, the local governments are less supportive of the private sector, focusing their energies instead on the state and, especially, collective sectors. Still other local governments are best described as having an ambivalent attitude toward private businesses; they are neither explicitly supportive nor unsupportive. I argue that these differing orientations toward the private sector in turn translate into varying degrees of implicit support for informal financial activity in any given locality. Local governments may choose to ignore the regulatory infractions of curb market insti-

Stoney Mao flanked by two goddesses at a TVE. Huian, Fujian, June 1994.

tutions, actively collaborate with local financial entrepreneurs, or make it very inconvenient for them to operate.

But why would local governments have such different approaches to dealing with the private sector? I suggest that the developmental orientation of subnational governments is primarily a path-dependent function of the economic structural legacies that localities inherited from the Mao era.[31] The importance of prior developmental experiences in shaping the economic reform process has been observed also in the context of the transitional economies in Eastern Europe and the former Soviet Union.[32] In China, some areas were intentionally deprived of investment capital, for geostrategic or other political reasons, during the first three decades of Communist rule. The regime was reluctant to build industrial capacity in the southern coastal provinces, for example, because of their relative proximity to Taiwan and thus their potential for destruction should full-scale warfare break out between the Chinese Nationalists in Taiwan and the PRC.

31. On how Mao-era legacies have influenced reform-era property rights arrangements in rural industry, see Susan H. Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (New York: Cambridge University Press, 2001).

32. David Stark and László Bruszt, *Post-Socialist Pathways: Transforming Politics and Property Rights in East Central Europe* (New York: Cambridge University Press, 1998).

Ironically, the relative poverty and isolation of such places put them in a better position later to engage in private income-generating activity. Even before the formal commencement of economic reform in 1978, governments in these areas quietly allowed decollectivization of land and a return to household-based production.

The case of Wenzhou in Zhejiang Province (Chapter 4) offers a vivid example of this dynamic. Wenzhou was once considered a remote, backwater district with few developmental prospects, given its limited arable land and dense population. Within the first decade of reform, however, Wenzhou had a bustling private sector and an equally active curb market. By the mid-1980s, informal financial activity had reached its peak: private money houses were charging interest by the hour; rotating credit associations had degenerated into Ponzi schemes; loan sharks were kidnapping relatives of debtors; pawnshops were brimming with fraudulent real estate titles; and state banks had experienced a massive outflow of savings deposits. Local economists estimated that 80 to 95 percent of the capital flows in Wenzhou were tied up in informal finance at the time. Although things have calmed down since then, the local government continues to be an ardent supporter of private enterprise and creative financing practices.

In contrast to the neglected localities, districts specifically targeted for industrial development were better off during the Mao era but slower in developing their nonstate sectors, because they now face the burden of reforming Soviet-vintage SOEs with large payrolls and outdated machinery. Governments in these areas exhibit ambivalence about private-sector development. They would like to see private-sector growth, but because of more pressing economic challenges they cannot devote limited resources to private businesses at the expense of the other sectors. The industrial cities in the north-central province of Henan (see Chapter 5), factionalized by competing developmental needs, are therefore ambivalent about the range of permissible financial institutions in their territories. Consequently, curb market institutions in the traditional heartland of China are encouraged to clothe their operations in ideologically palatable disguises, but they often bear the brunt of political campaigns against corruption and illicit financial activities.

The economic conditions of localities where the government tends to be unsupportive of private businesses lie at the extremes: they have been generally either extremely impoverished or highly collectivized with significant concentrations of rural industry under the leadership of strong commune and brigade institutions. In the latter situation, local officials have preferred to maintain close ties with (or de facto ownership stakes in) collective enterprises. In other words, collective rather than private economic activity has been the preferred engine of growth because the township and village governments, formerly communes and brigades, were accustomed to playing a central role in the local economy. In such cases, larger collective enterprises enjoy preferential access to existing financial institutions, while small-scale operators are left to their own devices to raise investment and working capital. Chapter 3 presents cases in Fujian Province which exhibit this tendency. Rotating credit associations, a mutual assistance–based form of informal savings and lending that can be found around the world, have become quite popular among female vendors in these localities.

Unlike local governments in highly collectivized areas, those in extremely destitute areas are not necessarily biased toward collective over private-sector development, but their physical locations may be so ecologically disadvantaged or isolated that outmigration appears to be the most expedient escape from protracted poverty. Such localities can be found even in provinces, such as Fujian (Chapter 3), which are now relatively more prosperous.

Although it is useful to classify localities in political economic terms, in reality both the structural condition and the developmental orientation of localities have changed since 1978. Local economies have not been frozen into discrete developmental categories or insulated from broader changes in China's political economy. They have evolved over time. By the late 1990s, for example, some localities that had been known for their dominant collective sectors were beginning to privatize their TVEs.[33] Furthermore, major shifts in the national political and economic environment have clearly had refractory effects at the local level. History-making events such as the Tiananmen Square crisis in 1989 and the Fifteenth Party Congress in 1997, which announced deeper restructuring of the state sector after Deng Xiaoping's death, redefined the macro context of interaction between national and local governments and the relative balance of power among central bureaucracies. Nonetheless, the point remains that the implementation of central policy is subject to interpretation at the grassroots level.

Although legacies from the Mao era have certainly shaped the developmental trajectories of localities, their actual paths have been dynamic and experimental rather than overdetermined. My concluding chapter elaborates on the local logics of economic possibility—in contrast to the top-down logic of the developmental state or the new institutional economic logic of minimizing economic uncertainty through well-defined property rights. Ultimately, individual staff of the state decide whether and how to enforce specific regulations, collect fees and taxes, and issue licenses.[34] Poli-

33. Oi, *Rural China Takes Off*; Whiting, *Power and Wealth in Rural China*.

34. Michael Lipsky, *Street-Level Bureaucracy* (New York: Russell Sage Foundation, 1983); Cf. James Ron, "Savage Restraint: Israeli, Palestine, and the Dialectics of Legal Repression," *Social Problems* 47, 4 (2000): 445–72.

Curbside capitalist, Kaifeng. Henan, July 1996.

cies are not implemented uniformly because individual agencies and bureaucrats are not implementing them uniformly. And more important, an integral part of their decision-making calculus in policy implementation stems from their interaction with local economic actors. Entrepreneurs can offer material, employment, and social incentives to their state-appointed regulators. Even as economic structure affects the immediate political incentives facing local officials and their rank-and-file cadres, it is equally apparent that private entrepreneurs themselves exercise agency in devising their financing strategies. By definition, entrepreneurs are not passive products of structural constraints; they are innovative actors who draw on preexisting resources to create new products for the market and new lives for themselves. This leads to the third puzzling issue.

Breaking Down the Private Sector

In addition to dramatic variation among localities in the scope and scale of informal finance, I found that business owners differ widely in their choice of financing mechanisms. This is the third puzzle: some private entrepreneurs rely primarily on personal savings or peer group rotating credit associations; others use the more highly institutionalized sources of curb market credit. Economists might attribute this diversity to the availability of certain financing mechanisms in any given locality. As rational choice theorists would put it, the local supply of informal finance constrains the choice set for private business owners. The limitation of this perspective is that entrepreneurs within the same locality exhibit wide variation in their financing behavior. Rationalists would expect similarly situated actors to make roughly similar economic choices, yet two storeowners, selling the same kind of merchandise and operating on the same street, may employ completely different financing strategies.

The solution to this third puzzle, I argue, lies in recognizing that private entrepreneurs have varying social and political identities. These mediate their access to noneconomic resources and networks, which in turn affects their economic strategies. In other words, private entrepreneurs as a group do not share equal access to the curb market even within a single locality because, economic similarities notwithstanding, they are not in fact similarly situated in other significant realms. As this book demonstrates, entrepreneurs' economic behavior also operates according to a social and political logic. Just as explaining the variation in the supply of informal finance invokes the political considerations of local officials, explaining individual use of financing mechanisms transcends bottom-line economic issues. Women in the coastal south who dominate rotating credit associations, migrant peddlers in an industrial center who rely on native-place networks for short-term credit needs, and former Communist Party officials who run private finance companies are all private entrepreneurs, but it would be simplistic to view them as sharing similar identities, resources, and interests. I found that business owners' financing practices vary with their gender, residential origin (local or migrant), length of time in business, and strength of local political ties. Local male business owners with strong political ties, for example, are more likely to tap the more highly institutionalized financing mechanisms than are migrant women who operate businesses at a similar scale in the same locality. Different entrepreneurs tap different forms of informal finance because they rely on different interpersonal dynamics to create the level of certainty and "credible commitment" that formal financial institutions and sophisticated property rights would theoretically provide. Informal credit markets are segmented even at the grassroots level. Access to social and political capital mediates access to finance capital. The so-called capitalist class is not a unified whole.

The importance of disaggregating both the state and the private sector, is that breaking down these broader conceptual categories exposes micro-level interactions between political and economic actors which are typically obscured by conventional economic or state-centric approaches. Entrepreneurs and bureaucrats are not single-mindedly motivated by, respectively, profit-making and policy implementation. They face a multidimensional array of constraints, opportunities, and incentive structures that vary by locality. For these reasons, entrepreneurs and state actors must be seen in both their local political economic contexts and their individual networks. Informal institutions at these lower levels of analysis constitute the unarticulated rules of a game that its players take for granted on a day-to-day basis—and that political scientists tend to ignore.

At the same time, however, this shift in focus to the contextual contingency and social embeddedness of the key players should not be taken to a deterministic extreme.[35] The apparent rules of the game are not static but are continuously renegotiated as state and nonstate actors interact. The norms that guide human interaction cannot be divorced from their daily reproduction.[36] Every time a state clerk registers a private enterprise as a collective one, or a restaurant owner treats a tax collector to a lavish banquet, certain norms are being chosen over others. These everyday transactions are more than practical acts of survival or symbolic acts of resistance.[37] They subvert the formal, state-defined rules of the game. They create alternative scripts, incentives, and even institutions. They generate new possibilities. In the aggregate, that is how private-sector development in China has been financed in the absence of official sources of credit. That is why the party-state does not monopolize the supply of capital in the economy. Ordinary acts and informal institutions can produce macro-level outcomes.

Beyond Control: Potential Lessons for the Party-State

In addition to demystifying the empirical puzzles, my theoretical claims have broader policy implications for the party-state's ongoing attempts to reassert its authority over the financial system and alleviate the capital constraints of private entrepreneurs through official channels. Both regulatory and redistributive efforts have met with limited success. In light of the operational reality of local hierarchies among business owners and their complex interaction with various staff of the state, the relative ineffectiveness of such policy interventions becomes more understandable. Political leaders in Beijing (and other capitals during the Imperial period) have

35. Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology* 91 (November 1985): 481–510.

36. Pierre Bourdieu, *Outline of a Theory of Practice* (Cambridge: Cambridge University Press, 1977).

37. James C. Scott, *Weapons of the Weak: Everyday Forms of Peasant Resistance* (New Haven: Yale University Press, 1985).

Family at work. Beijing, August 2001.

always recognized the challenges of standardizing governance in a country of China's size and diversity. Nonetheless, the statist tendency to assume both faithful policy implementation by subnational bureaucrats and citizen compliance remains. What are the effects of such flawed assumptions?

Approximately every other year since the initiation of economic reform, financial rectification campaigns have been conducted to reform mismanaged banks and close down unsanctioned financial institutions. Such campaigns, coupled with anticorruption campaigns, grew in intensity during the Asian financial crisis of the late 1990s. The center's heightened concern about financial system health was not surprising, but the effects of increased supervision and disciplinary action often surprised officials: public investigations of dubious financial practices triggered runs on banks, and when private finance companies were shut down, their customers took to the streets in protest. In order to understand and perhaps anticipate how regulatory scrutiny could have the unintended effect of sparking local financial crises, one must return to the basic yet critical point that local political and economic context matters. Official attempts at formalizing informal finance (or eliminating it altogether) disrupt the preexisting equilibria of local political and economic forces and introduce a potentially destabilizing element of uncertainty in the short run. When everyday consumers of private financial services realized that the implicit bargains struck between local governmental agencies and financial entrepreneurs were threatened by external intervention from above, they panicked—and lost confidence in state banks as well.

Thinking in market-oriented terms, national banking officials assume that entrepreneurs turn to the curb market because the formal financial system does not meet their credit needs. The logical solution, therefore, is to enhance the access of business owners to official lending institutions. Since forcing banks to engage in commercially viable lending has proved to be so difficult, funds have been allocated quota-style for small and medium private enterprises. Ironically, this means that certain types of "commercial" loans have become yet another component of the "policy" loans mandated by the state. The local reality of segmented credit markets, however, suggests that merely earmarking small business loans through a specific state agency or financial institution may leave out a substantial portion of the creditworthy population. In fact, such credit facilities may not even reach the intended group.

The paradoxical effects of state intervention in the informal financial sector are not unique to China; international development practitioners in microfinance have observed similar problems with state-directed credit programs in other contexts (Chapter 6). Examples abound of funds intended for agricultural credit being diverted for nonagricultural uses and subsidized microfinance loans landing in the pockets of local elites. This is not to say that the state cannot play a productive regulatory and redistributive role; rather, it is dangerous to assume that well-intentioned policies will have their intended effects. Legislative fiat should not be equated with legislative compliance.

State policies travel quite a distance between their genesis in air-conditioned drafting chambers and implementation at the ground level. This book makes a similar journey through each of the distorting dimensions of the process. To situate the emergence of informal finance in the context of China's broader developmental dilemmas, Chapter 2 identifies political and economic reasons for the structural exclusion of private entrepreneurs from the formal financial system and lays out my research methodology. Chapters 3 through 5 turn to the specific curb market experiences of various localities in Fujian, Zhejiang, and Henan Provinces and show how the seemingly straightforward economic issue of private-sector finance involves a network of complex interactions between political and economic actors. Case studies of localities, financial institutions, and entrepreneurs reveal that collaboration between the local government and the private sector can usually be traced to individual relationships. But it would be misleading to conclude that informal finance is merely a personalistic expression of corruption. Curb market activity depends on more than random acts of back-scratching among friends and family; the production of informal finance operates more like an underground factory fueled by a permissive configuration of local political and business interests. Of course, although common patterns of production technologies may be observed across localities with similar social and political economic structures, the process is not perfectly mechanical or predictable. Delays occur, accidents happen, and every once in a while the underground factory is exposed by higher-level regulators for what it is—illegal—and key divisions are shut down. But where the local government has compelling political reasons to look the other way, the underground factory finds a way to reconfigure itself and continue its business.

The stubborn persistence of informal interactions and informal finance is how China's economic miracle has been financed. Not the establishment of state-run commercial banks. Not the establishment of transparent property rights. In quiet and creative collaboration with local officials, private entrepreneurs have cultivated more accessible, if not always reliable, sources of credit for themselves.