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The Road to Capitalism: Competition and Institutional Change in China[1]

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We develop a theory of institutional change and apply it to analyze China's transition toward capitalism. We focus on how product market competition induces institutional change through the interaction between bureaucrats and managers in regional government-controlled economies. When cross-regional competition is sufficiently intense, each region has to cut production costs. Given that the efforts of managers are not verifiable, local governments may have to grant total or partial residual shares to the managers. In general, intense product competition stimulates the rise of a private property system. We submit our theory to a vigorous empirical test using China's industrial census data of more than 400,000 firms. The test supports strongly our postulation that cross-regional competition is the driving force behind China's transition toward capitalism. *J. Comp. Econ.,* June 2000, **28**(2), pp. 269–292. City University of Hong Kong, Kowloon, Hong Kong; and Peking University, Beijing, China. © 2000 Academic Press

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1. INTRODUCTION

Institutional arrangements, particularly property rights, are central to incentives and hence to economic performance. Under the condition that information about individual attributes and actions is largely decentralized, most economists agree that private ownership is the most high-powered incentive instrument. This view is supported by the fact that more than twenty former socialist economies, with about one-third of the world population, are trying to undergo the transition to capitalism.[2] Yet our knowledge of institutional change is limited. How do institutions change? What factors drive efficient institutional change? In particular, what are the driving forces behind the transition from government to private ownership? These questions provide both unprecedented challenges as well as opportunities for economists to study institutional change.

Among the transition economies, the Chinese case is particularly intriguing. When Deng Xiaoping and his comrades began the reform in 1978, no one, including Deng himself, expected to witness a nearly double-digit annual growth rate in the subsequent two decades and the rise of a predominant non-state sector. China's phenomenal performance is cited by some economists as an example of why privatization is not a necessary precondition for efficiency because the high growth rate in China has occurred under the dominance of public ownership (e.g., Stiglitz, 1994). Some argue that the success of township and village enterprises (TVEs), which are a form of collective ownership, challenges standard property rights theory (Weitzman and Xu, 1994; Li, 1996). However, the Chinese experience is not consistent with these arguments. In the last two decades, especially since the early 1990's, both state-owned enterprises (SOEs) and TVEs have been increasingly privatized and most newly established firms are private enterprises. In 1978, nearly four-fifths of the total industrial output in China came from SOEs. By 1997, the SOEs' share had shrunk to slightly more than a quarter (Statistical Survey of China, 1998, p. 99). The major players behind the rise of a private ownership system are local governments at various levels (China Reform Foundation, 1997; Cao et al., 1999).

Interestingly, the Chinese economic reform began with decentralization, rather than with the development of a private ownership system, and with revitalization, rather than privatization, of state firms. What are the driving forces behind the unintended and accelerating rise of a private ownership system in China? What motivates local governments to privatize the enterprises under their control and to issue licenses to newly established private firms?

The work of North (1990) and Weingast (1995) provides some hints about answers to these questions. North (1990) maintains that institutions are the rules

[2] "Capitalism," according to *Webster's Collegiate Dictionary* (ninth edition), is "an economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision rather than by state control, and by prices, production and the distribution of goods that are determined mainly by competition in a free market."

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