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Institutional Perspective of the Chinese Economic Reform

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"Ode to my friends and family"

ABSTRACT

The goal of this thesis is to explain the development of China in the past few decades by applying the institutional theory. It also overviews the other economic theories, such as neoclassical theory, and explains why they are not suitable for emerging economies and especially China. In line with this objective, the thesis tries to offer a deeper understanding about the peculiarity of China´s reforms and sheds a light about the usefulness and applicability of the lessons learned from Chinese reforms for other emerging economies. In this sense, the thesis tries to provide an insight into gradual and experimental nature of the reforms in China.

Key words: *China, Institutional Theory, Experimentation, Decentralisation, Gradualism, Reforms*

ZUSAMMENFASSUNG

Das Ziel dieser Dissertation ist es, die Entwicklung von China, in den letzten paar Jahrzehnten anhand der institutionellen Theorie zu erklären. Diese Arbeit gibt ebenso einen Überblick über andere Wirtschaftstheorien, wie die neoklassische Theorie und erklärt wieso sie für Schwellenländer und speziell für China, nicht anwendbar ist. Um dieses Ziel zu erreichen, will die Arbeit ein tieferes Verständnis über die Besonderheiten von Chinas Reformen kreieren, sowie ein Licht auf die Nützlichkeit und Anwendbarkeit werfen, in wie weit das Gelernte über Chinas Reformen, für andere Schwellenländer zu übernehmen ist. In diesem Sinne, versucht die Arbeit einen Einblick in den schleichenden Experimentalcharakter von Chinas Reformen zu bieten.

Schlüsselwörter:*China, Institutionelle Theorie, Experimentieren, Dezentralisierung, Gradualismus, Reformen*

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This accomplishment would not have been possible without them. Thank you.

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LIST OF ABBREVIATIONS

CCP	=	Chinese Communist Party
CJV	=	Cooperative Joint Venture
CRS	=	Contract Responsibility System
ED	=	Economic Decentralisation
EJV	=	Equity Joint Venture
EMNE	=	Emerging Market Multinational Enterprise
EU	=	European Union
FCB	=	Foreign-Controlled Business
FDI	=	Foreign Direct Investment
GLF	=	Great Leap Forward
HRS	=	Household Responsibility System
JV	=	Joint Venture
MNE	=	Multinational Enterprise
M&A	=	Merger and Acquisition
NIE	=	New Institutional Economics
OFDI	=	Outward Foreign Direct Investment
OIE	=	Old Institutional Economics
POE	=	Privately-Owned Enterprise
PRC	=	People Republic of China
RCC	=	Rural Credit Cooperative
SEZ	=	Special Economic Zone
SOE	=	State Owned Enterprise
SEZ	=	Special Economic Zone
TCE	=	Transaction Cost Economics
TVE	=	Township and Village Enterprise
WOFE	=	Wholly Owned Foreign Enterprise
WTO	=	World Trade Organisation

INTRODUCTION

China is the country that is currently undergoing a deep transformation. Some philosophers such as Hegel and Montesquieu use to characterise China as the never changing civilisation and paradigm of Oriental despotism, probably under the influence of Eurocentric view of the world and the fact that China chose to isolate itself from the rest of the world for the biggest part of the XIX and XX centuries.Then again, Napoleon Bonaparte said "China is a sleeping giant. Let her sleep, for when she wakes she will move the world." (China Daily, 2014)And that is what we have been witnessing for the last few decades. China is awake.

Today China accounts for 15 percent of world´s GDP and it has levelled up with the Europe for the first time after almost two centuries. (National Bureau of Statistics of China, 2016) Its GDP growth rates were unseen in the newest history. Same applies for the outstanding trade performances, the rapid growth of foreign direct investments and outward investments from China. Thanks to its profound involvement in the international division of productionChina became the world´s factory. The country also became the powerhouse of the global economy and its demand for goods and services pulled the development around the world. Despite slowing down of China´s economy recorded in the past two years, consumption still shows staggering growth. It is predicted that only in the next five years consumption will grow more than entire Germany consumption today. (Kuo, et al., 2015) From the scientific point of view, it would be reckless to ignore these changes, therefore this thesis will try to explain them.

In the first part of the thesis, the state of China´s economy today is explained. This will be an introduction in the second part, where the theoretical context is set. The second part deals with the institutional change and explains how and why institutions matter. At the focus is the institutional theorythat is crucial for the analysis of emerging markets.

This part provides a brief theoretical overview of institutional theory and it explains how it developed in the last decades. According to Peng & Meyer (2011), every country has its own specific sets of rules. These rules are also called “rules of games”, understanding of these rules is crucial for understanding foreign markets. The “rules of games” is basically context or environment, which is characterised by formal and informal institutions. Institutional theory is an approach to international business, based on the understanding of this environment and it has been established and described by Peng. This theory underlines that the institutions are more than background conditionsin a country and that they have a crucial function in the international trade. (Peng et al., 2009) While in western, mature and developed market economy institutions are almost non-visible, in emerging economies they are very apparent and their role is significant. Therefore, institutions that represent specific context for a country shouldn’t be ignored, because what is valid in one economy does not have to be valid in the other economy. Barney (2001)

Having this in mind, the institutional theoryisapplied in the third part of the thesis to clarify how China´s institution influenced the development of the country. By explaining the process of the reforms undertaken by China in the last 50 years it is described why was it achievable for China to accomplish such astonishing performances during its transition and why it wasn´t possible to do it before the reforms started. And how did China gradual abandon centrally planned economy and adopted the market economy, without changing the political system.

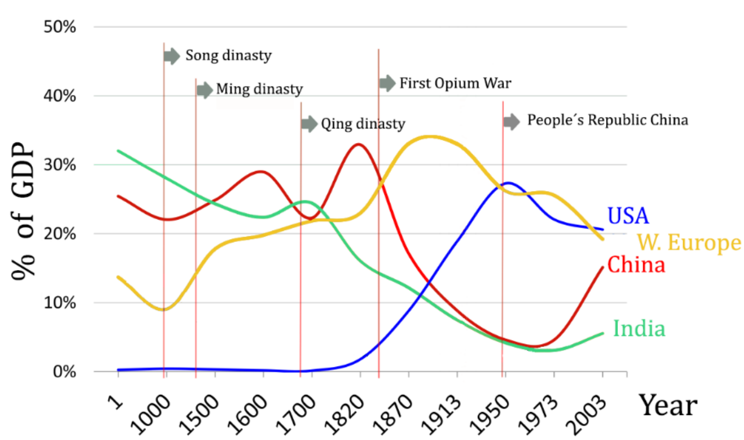
Gradualism and unclearness of the ultimate objectiveare the main features of Chinese reforms. China went into the reformswithout a clear blueprint to where they should lead. They were very spontaneous and experimental. The experimental feature of reforms meant that the local governments had substantial autonomy to try out different economic policies. Only those policies that were proven to work would be later adopted at a nation-wide level. Because the new rules were first introduced only in the few regions, it helped to contain possible negative consequences of reform only to participating regions, while the rest of the economy stayed undisturbed.Unlike many emerging economies, a big part of China´s reform was based on bottom-up principle. Therefore, the process of decentralisation played an important role. Dual-track economic system, the system that compromised of a resilient state sector based on state-owned enterprises and a vibrant developing privatesector is also unique for China. This way China represents a peculiarfusion between market and state controlled economy.

All these aspects of Chinese economy and reforms are clarified at the last part of the thesis as well as their significance for China´s economic development.

Asian countries, mainly China and India, dominated world´s economy for centuries. If the year 1820 is taken as the reference year, Figure 1 displays that those two countries accounted for almost half of the world´s GDP. However, their share in global GDP started to decline, Indian already in the 18th century and China´s in early 19thcentury. By the late 1970's they fell to less than 5 percent of the world´s GDP combined, although compromising almost 40 percent of global population.

In a turmoilperiod for China from 1820 until the 1950s, the world´s gross domestic product increased eight-fold and per capita income more than two and half times.At the same time, per capita income in China plunked,both in nominal terms and in relative terms. Per capita GDP fell to only one-quarter of the world average. China´s share of world GDP also collapsed from one-third to only five percent of global GDP. (Maddison, 2007)

FIGURE 1 PERCENT OF GLOBAL GDP 0 – 2012



SOURCE: ANGUS MADDISON, BASED ON OECD DATA(MADDISON, 2012)

The same graph also shows the rise of the West and new super power the United States, which rose from only 2 percent to almost one-third following the Second World War. Economic and with it political and ideologicalprimacyof the world moved westward, where it stayed until now.

Although this change was partially due to the progress of Westafter Reformation and Enlightenment movements, and especially after the industrial revolution, the main reasons for China´s downfall were unfavourable conditions in China itself. Chinese rulers, supported by bureaucracy, led isolationistic, ethnocentric policy, which has ignored development outside the China for a long time. The isolationistshave valued their obsolete social system and opposed reforms and innovations. Therefore, they didn´t succeed to respond effectively to the western technology advances until the mid-1900s. (Maddison, 2007)

Additional, the reasons that contributed to China´s decline were internal disorders and colonial intrusions. In that period externally, China was repeatedly beaten by imperialist foreign powers in aggressive wars. The country faced colonial intrusions, led two so-called Opium wars with the United Kingdom and France, three with Japan and one against the Allied forces in 1900. These wars and their consequences left China socially and politically humiliated, and economically devastated.

Internal disorders have also contributed significantly to China´s downfall. These disorders have emerged due to backward and outdated economic and political system. Together with accumulated social and religious tensions, they have triggered several rebellions in China, the most notorious werethe Taiping rebellion (1850–64) and theseries of Muslim rebellions.

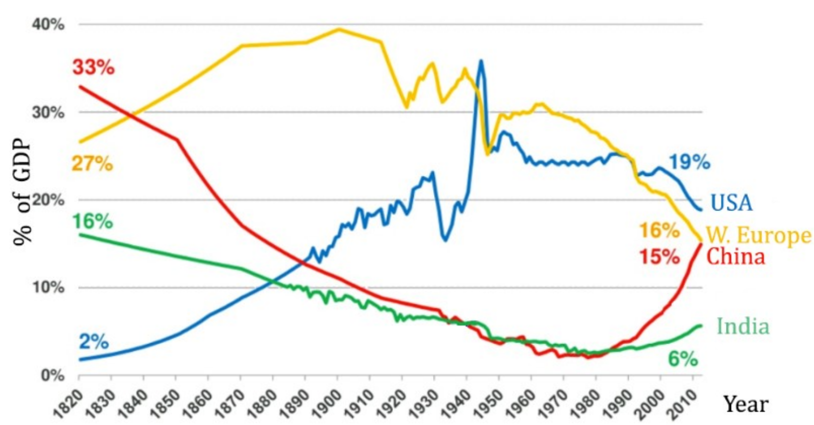
After the period of rebellions, Republic of China was established in 1911, when the last feudal Qing dynasty was overthrown. At that point, China found itself in a state where there was a power gap and thisproduced extensive fighting for power between warlords. Civil wars between the communists led by Mao Zedong and the nationalist Kuomintang led government (1927–49) also produced major disorder to Chinese economy and society. (Tian, 2007)

Only after the Mao Zedong´s forces won the China´s civil war and established People's Republic China (PRC) in 1949,the sharp break with the past was made. The next three decades were a period of an internal political fight among communist leaders and unsuccessful social and economic experiments under the leadership of Mao Zedong, who installed in China orthodox Marxist-Leninist regime based on the centrally planned economy. Only after his death, pragmatic leaderDeng Xiaoping initiated real reforms that returned China on the world stage after few centuries absence. Under his leadership, China relinked with the world's market and opened to the world. The countrymoved away from the centrally planned economy to a market economy and adopted one country two system philosophy. Xiaoping's reforms skyrocketed Chinese economy. (Tian, 2007)

THE RISE TO POWER

After the century and half of turmoil and lacking behind the rest of the world, and decades of reforms,China has become one of the strongest economies in the world, and in the term of GDP second after the USA.In the past three decades, the country had the fastest growing economy in the world and in 2016 it accounted for 15 percent of world´s GDP and almost accomplished to level-up with Europe after more than two centuries. (National Bureau of Statistics of China, 2016)At the same time share of Europe and the USA in global GDP experienced fall, but still,it accounted for 35 percent of global GDP in 2012. (Maddison, 2007)

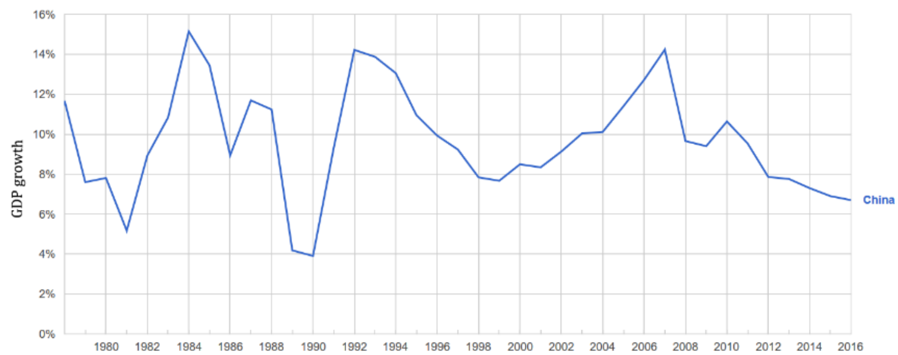
FIGURE 2 PERCENT OF GLOBAL GDP 1820 - 2012



SOURCE: ANGUS MADDISON, BASED ON OECD DATA (MADDISON, 2012)

China went long way in the past few decades from the isolated country ravaged by famine to the country that is now called the global factory. In the last decade,China was the biggest recipient of foreign direct investment among developing countries and had the average yearly gross domestic product (GDP)growth of almost 9 percent in the past three decades. Although, the Chinese economy is experiencing slow down its GDP growth in 2016 was still 6,3 percent. (Figure 3)

FIGURE 3 GDP ANNUAL GROWTH RATE (1978-2016)

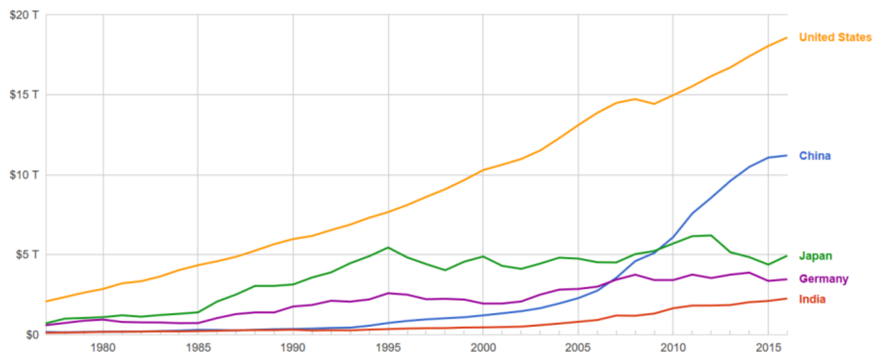


SOURCE: THE WORLD BANK (2017)

The economic success of China had important global implications because it createdenormous demand for capital, goods, and services globally. Even though Chinese economy is struggling to overcome problems it´s facing with the structural transition, Chinastill has the role of the powerhouse of the global economy. Consumption in China has the staggering growth and it is expected that in the period 2015-2020 will grow 2,3 trillion US$, what is 30 percent larger than entire consumer market of Germany or the United Kingdom today. (Kuo, et al., 2015)

China GDP in the last three decades has also experienced the growth unseen in history. Its GDP grew from 0.15 trillion US$ in 1978 when the reform started to 11.2 trillion US$ in 2016. In 2007 China overtook Germany as the third biggest economy in the world and Japan as the second biggest three years later. (Figure 4) Despite, the slowdown in GDP growth rate in the last years, it is still expected that China may overtake the USA in the decades to come.

FIGURE 4 GROSS DOMESTIC PRODUCT US$



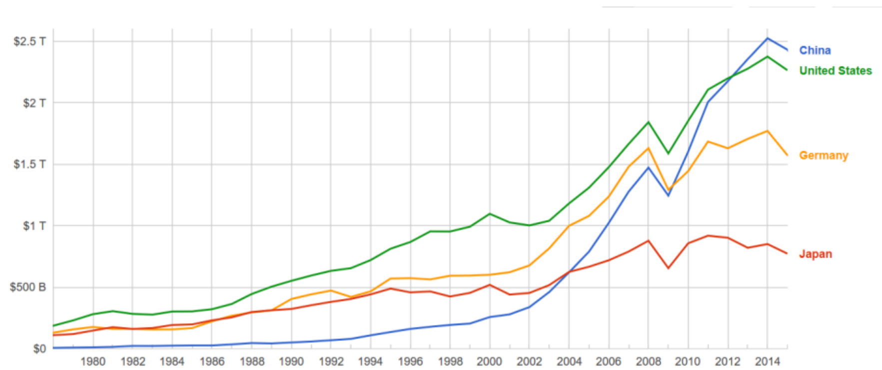
SOURCE: THE WORLD BANK (2017)

FOREIGN TRADE IN CHINA

In international business China is also playing a significant role, with the market of 1,37 billion people and economic growth unprecedented in the newer human history, it became a magnet for foreign investors that wanted to use comparative advantages of this huge developing country. Investing in China became a trend or even necessity in the past decades. Business opportunitieswere enormous.

Before Xiaoping´s reforms, China almost didn´t have any trade with outside world. In just a few decades it became the most important player in international trade. Figure 5 displays that already in 2012 China managed to overtakethe USAas the biggest exporter in the world. In the year 2015 country exported 2.4 trillion US$ of goods and services. In compresence with 1978 when the export was just 0.06 trillion US$ this represents a fortyfold increase in export value.Additional, China has the biggest trade surplus globally, and since 1993 the export values were always bigger than the imports, alone in the year 2015 trade surplus amounted 0.2 trillion US$. (The World Bank , 2017)

FIGURE 5 EXPORT OF GOODS AND SERVICES

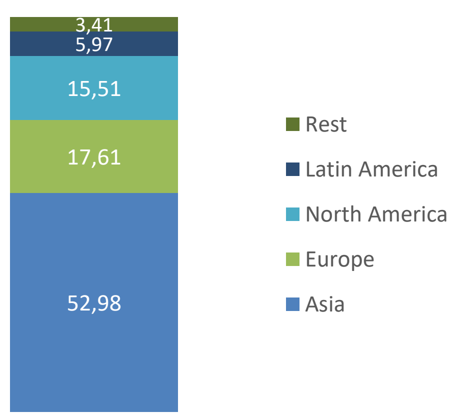


SOURCE: THE WORLD BANK (2017)

It is also important to note thatin the past years China experienceda big change in the composition of trade. While in the early years of reforms China exported 50 percent of primary goods and 50 percent of manufactured goods, 25 years later more than 95 percent of China´s exports were manufactured goods. (National Bureau of Statistics of China, 2016) This fact shows that the strong process of industrialisation took place in China.

Geographically seen, the main trading partners of China are in Asia and theyaccount for more than 50 percent of the total trade, followed by Europe and North America. (Figure 6)

FIGURE 6 CHINESE TRADE PARTNERS SHARE (2015)

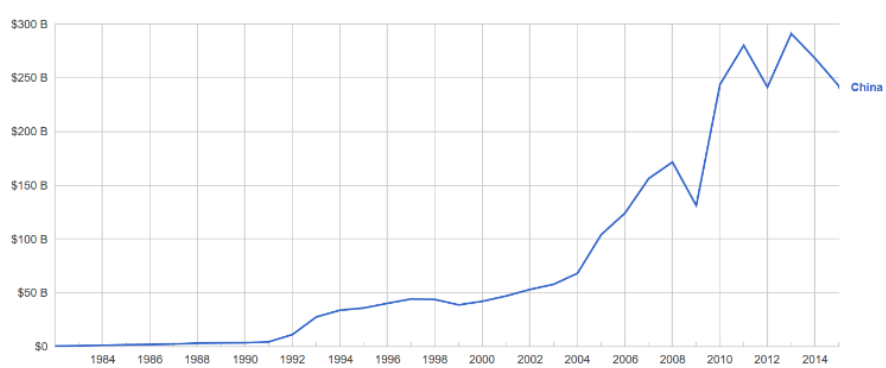


SOURCE: NATIONAL BUREAU OF STATISTICS (2016)

FOREIGN DIRECT INVESTMENT (FDI)

For centuries China was closed for foreign capital. Only after introducing Equity Joint Venture Law in 1979, China opened itself for foreign direct investments (FDI). At the beginning inflow of FDI was negligible, only in 1984 China manage to surpass 1 billion US$ of FDI annually. The value of foreign investments stayed relatively low until Chinese president Deng Xiaoping didn´t embark on famous South tour in 1992. Xiaoping inspected newly opened economic zones in coastal China and called for modernisation and new opening-up economic policy, which eventually kick-started Chinese economic boom. Ever since, the country became one of the biggest recipient of FDI globally and the biggest among developing countries. From 1992 and start of the opening-up policy,FDI inflow exploded and it reached its peak in 2013 when China received around 291 billion US$ FDI. In the past two years trend of declining FDI can be observed.(The World Bank , 2017)Figure 7 displays trend of ever increasing investment, although some fluctuations can be observed after Asian financial crisis of 1997 and after world financial crisis of 2008. To deal with the negative impact of the global financial crisis, Chinese government decide to launch a major investment programme. Large amount of money wasinvested in real estate and infrastructure, however, once overcapacity had been reached, the fall of investment has pulled the entire economy into a considerable slowdown.(Amighini, 2015)

FIGURE 7CHINA FDI 1980-2015



SOURCE: THE WORLD BANK 2017

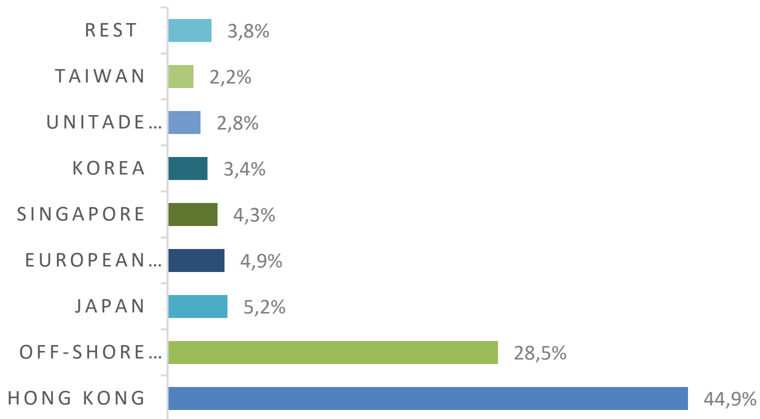
SOURCE AND DESTINATION OF FDI

If we observe the source of the FDI in the period 1978-2004, the biggest contributor to China´s FDI was Hong Kong, with 58 percent of all FDI, followed by Taiwan, the United States, and Japan with 8 percent each, Singapore 3, the United Kingdom 2, and all the rest 13 percent. (Tian, 2007, p. 26)

At the beginning,almost entire FDI from Hong Kong had Guangdong province as the FDI destination. Geographical proximity played animportantrole because Hong Kong is surrounded by Guangdong province. FDI came mainly in the form of therelocation of the great number of manufacturing enterprises to the neighbouring Guangdong SEZ. The main reasons for relocation were low wages, inexpensive land, vicinity, apolicy that promoted export, same language, and similar culture.

In period 2004-2012 Hong Kong kept firmlyits first position as the largest investor to China, although its relative share declined. The country was followed by offshore destinations Caribbean, British Virgin Island, and Cayman Island. (UNCTAD, 2014)Domination of investor from Asia is significant, their investment accounted for 70 percent of all FDI.The United States lost its significance and in the fell to seventh positionin the list of the biggest investors to China. (Figure 8)However, domination of Hong Kong is questionable because much of investment is only passing through it and their source is elsewhere, same applies for offshore destinations. It is well known that these locations are places to deposit money, so-called investments hubs and the capital itself is basically not traceable. (Granneman & van Dijk, 2015)Nevertheless, a lot of foreign enterprises use Hong Kong as their starting point for investing in China.Investors see advantages compared to mainland China, in developed, stable, and accessible legal system that is based on English Common law, guarantee intellectual property protection, andunbureaucratic, efficient and cost-effective administration.

FIGURE 8 SOURCE OF FDI 2004-2012



SOURCE: UNCTAD 2014

ENTRY MODE

Before the introduction of the Law of the People's Republic of China on Sino-ForeignEquity Joint Ventures (EJV) in 1979, the only mode to invest in China was exporting that represents a very traditional form of international business. At the beginning of the opening-up process, only EJVs were encouraged because for the central government it represented the fastest way to procure new technologies and at the same time keep the control over the industry. In 1986 new law allowed an establishment of the Wholly Foreign-Owned Enterprises (WFOEs) as the form of entry was introduced. Two years later Cooperative JointVentures (CJVs) were also allowed. CJV is an enterprise form that is based on a contractual agreement between a local Chinese firm and a foreign firm. The foreign companymust hold no less than 25 percent of thetotal shares of the CJV.

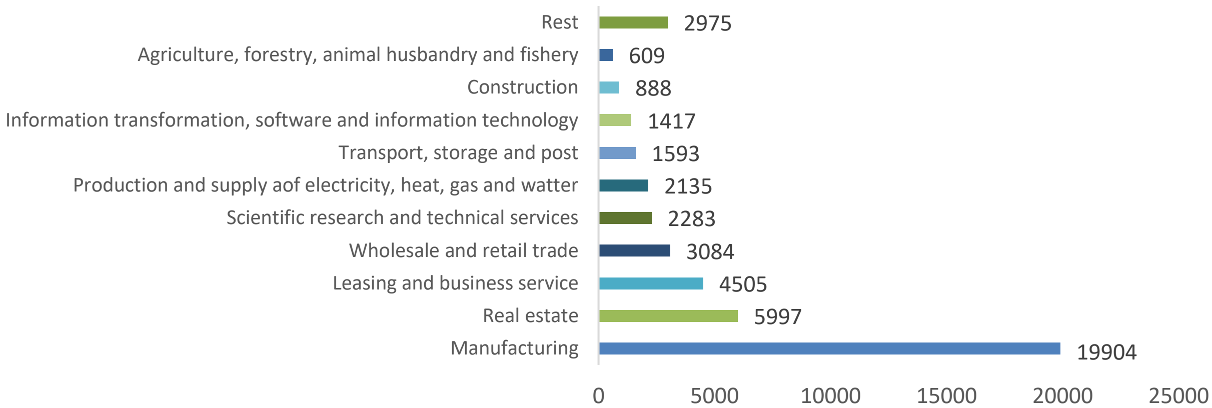
Until the introduction of the WFOE related laws more than 90 percent of all FDI came in form of EJVs, however, already in the late 1980s and early 1990s WFOEs were the most common mode of foreign capital entry in China. (Tian, 2007)

According to China's Statistical Yearbook, foreign investments are divided into two general categories. The first is foreigndirect investment that includes equity joint ventures, contractual (cooperative) joint ventures, wholly foreignownedenterprises, FDI shareholding Inc., joint exploration, and others. The second category is named other foreign investmentand it incorporates share sale, international lease, compensation trade,and processing and assembly. Despite, different types of mode that the investors had at their disposal, in the year 2015 only direct investment and four modes were chosen. Out of 26575 projects around 77 percent were in the form of WOFEs, 22.5 percent EJVs, 0.5 percent in the form of CJVs, and only 78 FDI shareholding Inc. (National Bureau of Statistics of China, 2016)

SECTORS OF FDI

Considering the type of industries that allow FDI, China started with the oil explorationprojects and up to today, FDIs are allowed in the wide range of industries. The most of the investment in the period since the start of the reform until 2004 went into the secondary sector around 60 percent, 38 percent in tertiary and below 2 percent in the primary sector. Foreign investors wanted to utilise and take advantage of low labour costs in China and mainly invested in labour intensive industries, therefore the biggest investment went into manufacturing sector. In the last years, this trend has changed slightly, and the share of manufacturing in FDI started to decrease steadily, while the tertiary sector is gaining significance. Although the share of FDI to the primary sector was never high, in 2015 primary sector decreased even more to only 1.3 percent of all FDI, while manufacturing fell to around 44 percent. The rest, almost 55 percent, went into tertiary sector, where real estate sector alone attracted 13 percent of FDI. (Figure 9)

FIGURE 9FOREIGN DIRECT INVESTMENT BY SECTOR (2015) IN 100 MILLION US$

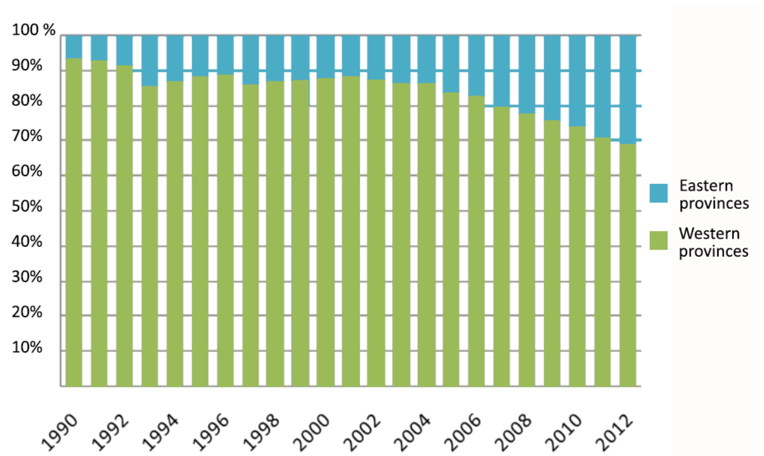


SOURCE: NATIONAL BUREAU OF STATISTICS (2016)

GEOGRAPHICAL DISTRIBUTION OF FDI

When the destination of FDIis concerned, investments are significantly uneven distributed. In the beginning of the 1990s, the vast majority of all FDI to China ended up in coastal provinces, particularly Guangdong province,with more than90percent of the total FDI. Coastal provinces and western provinces, in general, enjoyed significant infrastructural advantages. Located next to them, Hong Kong, Macao and Taiwanplayed the majorrole in their development and success, especially considering the fact that they were among the biggest investors in Mainland China. Additional, a lot of manufacturing, in particular, those labour-intensive, from them, especially Hong Kong,were moved to theseborder areas in China. China´s decision, at the beginning of the open-up process, to restrict investments only to these coastal areas, also contributed to their supremacy. On the other hand, the interior of the country was closed for foreign investments. Only in the 1990s, China opened first special economic zones for foreign investors in interior provinces and after accession to World Trade Organisation (WTO), all location restrictions were removed. Consequently, the eastern provinces are todaysignificantly better off than the western provinces.The problem of uneven development of the country became too obvious, therefore in 11th and 12thfive-year plan,the Chinese government set as the priority to reduce the gap between the development of east and west provinces. Policies that were later adoptedhadthe cleargoal to attract more FDI to inland. As a result, FDI is starting, veryslowly to distributemore evenly across the country what is also obvious from the Figure 10.(Granneman & van Dijk, 2015)Still,in the year 2015 eastern provinces attracted 84 percent of all FDI. (National Bureau of Statistics of China, 2016)

FIGURE 10 SHARE OF REGIONS IN FDI



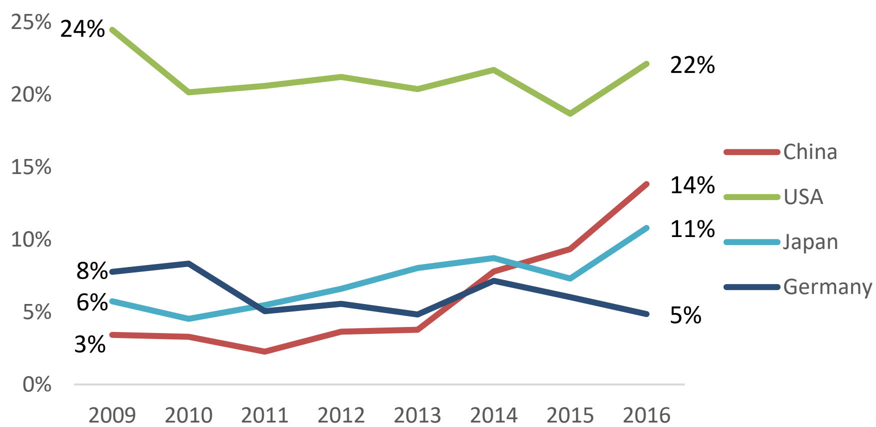
SOURCE: GRANNEMAN & VAN DIJK, 2015

OUTWARD FOREIGN DIRECT INVESTMENT (OFDI)

Traditionally, foreign direct investment was seen only as a one-way street, from developed economies into the emerging or undeveloped economies. However, this process changed in last decade and the new trend is emerging a dramatic increase in China's OFDI. Often supported by their governments emerging market multinational enterprises (EMNEs) are becoming fundamental global players in various industries. Chinese companies arose as the leading investors both in developed and developing economies. They are investing viciously around the world and becomingthe world´s biggest investors.

In 2016 Chinese OFDI accounted for 14 percent of the global FDI, this dramatic increase is even more notable if we consider the fact that China reached 3 percent of global OFDI only in the year 2009. After overtaking Japan in 2015,Mainland China is now ranking as the second largest home economy of outward FDI after the USA.(Figure 11)

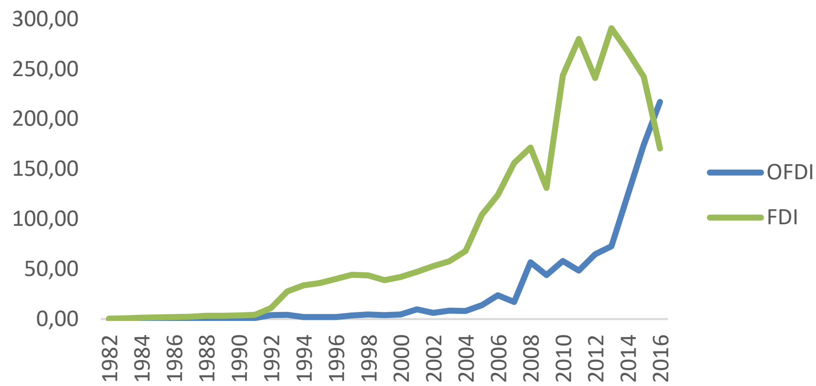
FIGURE 11 SHARE OF WORLD OFDI



SOURCE: THE WORLD BANK 2017

Chinese OFDI for the first time in 1992 was above 1 billion US$, twenty years later it amounted 65 billion US$. Last year Chinese OFDI reached 170,6 billion US$, more than 42-fold increase compared tothe year 1999, when Chinese government introduced a policy that encouraged domestic investment to "go out" of the country. Additional, for the first time in history, in 2016 Chinese outward FDI was bigger than its inward FDI. Bothdecrease in Chineseinward FDI to the lowest point since post crisis 2009 year and the spike in outward FDI contributed to this fact.In the last decades China´s economic growth hit the double-digit, however, this growth ended. China’s economy must adapt to the “new normal” where growth rates are significantly lower. Expansion of OFDI and especially “Road and Belt” policy is a part of the strategy to overcome the problem of falling FDI.

FIGURE 12 CHINA´S INWARD AND OUTWARD FDI



SOURCE: THE WORLD BANK 2017

"ONE-BELT-ONE-ROAD"

In 2013, during his visit to Central and Southeast Asia, Chinese President Jinping Xi started promotion of the new Chinese opening-up policy. He called upon jointly building"21st-Century Maritime Silk Road" and "Silk Road Economic Belt". These projects are also called "One-Belt-One-Road" or short "Belt and Road", it is sometimes also called "New Silk Road" referring to the ancient trade corridors that were connecting Asia with Africa and Europe for centuries. Since2015, when Chinese government drafted the "Belt and Road" strategy, they arestronglypromotingit as a part of new Chinese foreign policy with a goal of strengthening its global soft power. (Fan, et al., 2016)One of the goals of "Belt and Road" policy is to find new markets for abundant Chinese goods and to find the new waysto export China's enormousmanufacturing capacity by promoting regional cooperation in Asia, Africa, and Europe. An additional goal is that the entry barriers should be eliminated, investment speeded up, and trade cooperation improved.

"Belt and Road"project represents futurevast transport network in the Eurasian area. A network of highways, railroads, sea- and air-ways, gas and oil pipelines, communication networks and transmission lines. (Figure 13) "Belt and Road" route passes through 65 countries, with 4,4 billion inhabitantsandaround 21 trillion US$ of disposable income, accounting for 29 percent (“Road”) and 63 percent (“Belt”) of global capacity respectively.(Yiwei, 2015)

One-Belt-One-Road strategy steereda boom in China's OFDI and it is also closely linked to China’s expansion and development as a trading nation. (Deng, 2013)

FIGURE 13 SILK ROAD ECONOMIC BELT AND MARITIME SILK ROAD

SOURCE: JOC.COM

The development of Chinese OFDIafter 2015 was strongly influenced by the “Belt and Road” strategy. Countries along itbecame the highlight of Chinese investments. The share of the newly-signed contracts for the projects in these countries accounted for 51,6 percent of all newly-signed contracts with a value of 126 billion US$.Some 56 new cooperation zones were established and 1082 enterprises were engaged in cooperation with the capital of around 51 billion US$. Around 180 thousand new jobs were created and tax paid to the host country amounted to 1,07 billion US$ in tax were paid to the host countries along the “Belt and Road”.(MOFCOM, 2017)

MOTIVES FOR OFDI

When considering the investment in developed countries, OFDI from China has also rising trend. For the first time, China invested more in the US, than another way around. Some of the most prominent investment were HNA Group 6 billion US$ bid for technology distributor Ingram Micro; Chinese based consumer electronics and home appliances company Haier acquired GE home appliances unit for 5,4 billionUS$; Wanda Group, Chinese multinational conglomerate corporation spent 7,2 billion US$ for acquisitions in the entertainment industry; In Europe China's National Chemical CorporationChemChina a state-owned chemical company offered 43 billion US$ for Syngenta, a Swiss seeds and pesticide enterprise and the world's largest crop chemical producer.

The main mode of Chinese investment in developed economies is through merger and acquisition (M&A). In 2016, Chinese companies engaged in 742 M&A projects with the transaction value of 107,2 billion US$ in over 73 countries and regions. (MOFCOM, 2017)

The goal of M&As is not only to acquire natural resources, but acquisition of scale, new markets for growth, and critical strategic assets (talents, brands, managerial know-how, technology, intellectual property) (Deng, et al., 2017)

Quer et al. (2015) recognised two main type of OFDI asset- and market-seeking OFDIs. A lot of Chinese companies choose catch-up strategies to overcome a disadvantage of latecomers. Through the aggressive acquisition of mature MNEs, they are compensating their competitive weaknesses. This strategic asset-seeking OFDI is mostly undertaken from the large SOEs. Government support in this endeavour representsinstitutional complement for offsetting the competitive weakness. (Deng, 2013)

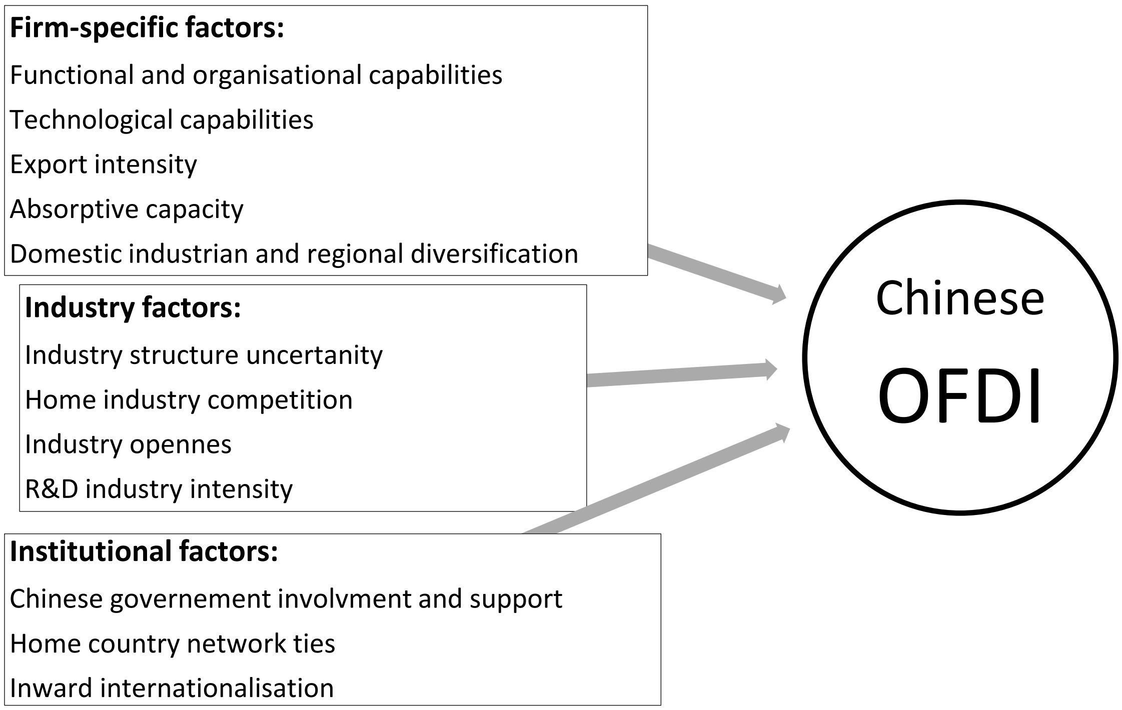
When considering reasons for investing and conditions in developing countries scholars have drawn more conclusions. Unlike their western counterparts, Chinese MNEs are well equipped to easily manage corrupt conditions in host countries, they are also not very sensitive to political risks and they are even attracted to it. Therefore, part of the Chinese OFDI is ending up in the countries that have undeveloped institutions, but large naturalresources.(Quer, et al., 2015)When considering consequences of Chinese OFDI in developing countries some of theresearchersclaim that the investment by Chinese MNEs, with governmental support, help these countries, especially in Africa, to achieve sustainable industrialisation. Also, Chinese government use OFDI as a tool for developing diplomatic connections that will eventually support another project that better reflects Chinese national interests. Being state controlled, SOEs are less sensitive to political risks in the host country and are more prone to engage in risky unconventional behaviour. (Deng, 2013)China is leading so called value-free diplomacy toward developing countries, meaning that it concentrates its effort not to moral principles but to the economy and other and strategic interests, unlike Western diplomacy. Therefore, it managed to develop rather friendly relations with a lot of developing countries, especially in Africa. (Zhao, 2015)

Quer et al. (2015) have analysed 112 research papers, published between 2002 and 2014 in major peer-reviewed journals that focus on Chinese OFDI. Theirresearch dealt with the drivers of Chinese MNEs to invest abroad and three main factors that influence Chinese OFDI has been recognised (Figure14):

1. **Firm-specific factors**, capabilities and resources increase OFDI: finance, sales, production, operations, organising capabilities, resourceendowment advantages, domestic industrial and regional diversification. For example, the companies that pursue low price with high volume business philosophy are driven by innovation, efficiency, volume, and service.
2. **Industry-specific factors** influence MNE´s capability to invest abroad. Industry structure uncertainty increases OFDI. Competition at the home market forces technologically more advanced firms to pursue internationalisation. If the industry is opened companies engage in strategic-asset-seeking investments.
3. **Institutional factors.** Support from government played a crucial role in increasing Chinese OFDI. Large and well-connected Chinese firms, particular SOEs profit from institutional support. However, not all the companies are able to take advantage of the government support, especially the private ones. Therefore, private and smaller companies engage more often into an asset- and market-seeking OFDI to compensate for the unfavourable environment and institutional constraints.

Importance of Institutional factors and influence of Chinese institutions in general on development of the country can be explained with the institutional theory.

FIGURE 14 MAIN DRIVERS OF CHINA´S OFDI



SOURCE: OWN REPRESENTATION BASED ON QUER, ET AL. (2015)

INSTITUTIONAL PERSPECTIVE

To understand the changes and trends, whichwere mentioned inthe previous chapter, and which are affecting the world, a different approachto the understanding of changes in the economy should be applied. This different approach should be based on the understanding of institutions. The concept of institutional influence on the economic performance of society is not a new concept in economic theory. Already in the early XX century, Adam Smith hasobserved this influence. In his book Wealth of Nations, he argues that, despite the physical shortcomings of English colonies in Americas in comparison with Spanish and Portuguese colonies, their economic progress was more significant, due to institutional framework that was in favour of improving and cultivating the land. (Smith, 1939)Also, some of the modern scholars such as DiMaggio and Powell (1983), Scott (1995) and Williamson (1996) have also highlighted the real importance of institutions for the economy.

Although the concept that highlights importance of institutions for economic developmentis not anew phenomenon, it hasn't been researched as much as the other perspectives and available literature is not as abundant. Only last few years with the rise of Chinese economic wonder, scholars started to engage more in researching institutional perspective, because all available theories could not explain China´s economic boom.

DEFICIENCY OF NEOCLASSICAL APPROACH

Throughout the history, it was known that institutions are important for economic performance, yet in the first half of XX century, when neoclassical economics, as a set of approaches to economics, was at its peak, this fact was neglected. In mainstream economics from the late 1940s until around 1970 institutions were virtually a taboo. LikeFurubotn and Richter (1991) specified it: "The existence of political, legal, monetary, and other systems was certainly recognised; but either these systems were regarded as neutral in their effect on economic events and ignored, or they were taken as given and then specified in so perfunctory way as to suggest that institutional influence was not of much importance." (Eirik Furubotn, 1991, p. 2)

Deficiency of approach where institutions have been assumed as background became more evident when dealing with emerging economies. While marketswere working in developed economies, institutions supporting that market were invisible. After the fall of communism in Eastern Europe inthe early 1990s, it was obvious that neoclassical approach to the economy is not sufficient to explain the process.

According to the neoclassical theory, that is based on mathematical principals and abstract economic models,the institutional framework was given and the only institution that exists is a competitive market, where the prices are the source of all information on the economy. The rational decision maker is maximising its utility and possess full and relevant information because values are given and the market is in equilibrium. Because of the premise that decision maker can choose from numerous alternatives the best possible, it is not possible to distinguish between its perception of the world and the real world, they are the same and under that assumption, it is possible to predict decision maker's decisions. Therefore,it can be concluded that the shortcomings of neoclassical approach are in disregarding of institutions that are crucial for the understanding of real-world events and ignoring the fact that actors are confronted with incomplete and complex information and their mental capabilities are limited. (North, 1990) The absence of institutional content ultimately turned out to be a problem both on a theoretical and practical level. This led to a revival of interests for the institutional framework and eventually to the development of "institutional economics".

INSTITUTIONALISM

Institutional economic highlights importance of institution and insists that institutions must be thoroughly studied and explained.There are two different approaches to institutionalism, new and old institutional economics. It is crucial to distinguish them, because new institutional economics (NIE) represents merelya variation of modern neoclassical theory, while old or "American" institutional economics (OIE) brings important ideas about the institutions and came to distinguish itself from NIE. Old institutionalism that appeared early in the twentieth century revolves around institutions that are seen as the key rudiments of every economy and economy represents an ever-changing and open system, set in “a natural environment, influenced by technological changes, and embedded in a broader set of social, cultural, political and power relationships”(Hodgson, 2001, p. 97). Additionally,OIE offers further clarifications for human behaviour, where individuals are not seen merely asutility-maximising agents, but as agents that create and affect the institution. Anotherway around institution affects individuals significantly as a part of the two-way process. (Hodgson, 2000)

Old institutional economic, arose as a criticism of the neoclassical theory and dissimilar to the new institutional economics had an ambition to fully replace neoclassicalapproach. Unlike NIE that argues that institutions exist independently from individual behaviour, OIE claims that institutions are dependent on individuals and exist through their behaviour. However, OIE doesn’t try to explain this relation in detail. Moreover, OIE doesn’t peruse to clarify the source of institutional changes. (Van der Steen, 2006)

Different from OIE, NIE integrates developments of neoclassical economics and accept its modified and weakened abstract assumptions theory of neoclassical economics. It uses OIE view on institutions and acknowledges their importance. However, among different approaches to old institutional economics, the one that recognises transactions costs as a descriptive element i.e. visible-hand approach, is the most important for NIE. (Richter, 2015) An additional connection between old and new institutional economics is in recognition of bounded rationality. Indeed, informational, and cognitive constraints influence the formation of institutional rules. (Rutherford, 2001)

NIE approach helps to describe the role of the institutions in society and helps to achieve a broader understanding of the topic, because it overcomes inadequacies of neoclassical theory, extendsit, and represents very good perspective for explaining economic and social issues. Some scholars find that NIE enlarges the competence of neoclassical economics; the others see neoclassical economics only as a starting point for NIE, while some see it as sui generis.(Pejovich, 1999) Either way, NIE takes institutions as an object of research and tries to answer, “How could rational actors be constrained (or constrain themselves) not to pursue their self-interest” and not what would they do. Neoclassical theory and NIE have the same base individual rational choice given the constraints and methodical individualism, but NIE acknowledges that because of information costs (transaction costs), full information is not available, therefore institutions matter.(Rutherford, 2001)

Transaction cost economics (TCE)is an important source of institutional perspective and it was established by works of Ronald Coase in 1930s and Oliver Williamson in 1970s. Analyse of transactions costs is an important part of NIE, TCE can be described as a theory of coordinating transactions among and inside business organisations. TCE argues that organisations that are facing transaction costs (costs of opportunistic behaviour, supervision cost, contractual costs etc.) will try to minimise these costs by choosing the most optimal governance structure. (Van der Steen, 2006) In classical economic theories, transaction costs were mainly ignored, however, NIE states that goal of institutions in an economy is to minimise transaction costs by reducing uncertainties and creating stable structures that simplify interactions. (Hoskisson, et al., 2000)

However,TCE assumes well-developed, relatively static market mechanisms, ignoring different institutional frameworks depending on countries. To overcome this challenge Williamson (1991) has proposed observing institutions as “shift parameters”, implying that institutional differences are simple control variables. This approach to intuitions would disregard the importance ofunderstandingthe institutional framework for actors. (Meyer & Peng, 2005)

INSTITUTIONS

In the previous chapter, it has been established that the institutions matter and how economic theory sees institutions, this chapter will try to explain institutions as an integral part of the economic system and their importance.

Institutions can be defined as thelegal, political, economic, and social organisation of a society, i.e. rules that establish the foundation for distribution, production, and exchange. According to Douglass North (1990) during history, humans have developed institutions in order to create order and diminish uncertainties. Political uncertainties may hinder successful long-term planning, and economic uncertainties, like pulling-back from a contract, produce losses; meaning that uncertainties, in general, diminish readiness for long term commitments. The goal of institutions is to reduce uncertainty and that implicate to avoid possible devastation. They do that by communicating to actors what behaviour is acceptable. (Peng & Meyer, 2011)The main goal of institutions, reducing uncertainties,could be achieved by instituting exact the same rules of behaviour for all participants. (Peng, et al., 2009) These rules of the game represent an institutional framework that regulates economic performance in society. By providing the structure of incentives, institutions directly influence economic trends towards decline, stagnation, or growth. Organisations are then created that will use the advantage of incentives provided by intuitions. Therefore,interactions between organisations and institutions shape economic activities and directly influence strategic choices that firm makes. Institutions tend to create a stable structure though not essentially efficient. (North, 1990)

There is also mutual influence between actors and institutions, Peter Hall points out "Institutional factors play two fundamental roles…. On the one hand, the organisation of policy-making affects the degree of power that any one set of actors have over the policy outcomes…. On the other hand, an organisational position also influences an actor's definition of his own interests, by establishing his institutional responsibilities and relation to other actors."(Steinmo, et al., 1992, pp. 2-3)

FORMAL VS. INFORMAL INSTITUTIONS BY NORTH

Institutional framework in a society is based on distinguishing formal and informal institutions. Formal institutionscontain property right, law, constitution, contracts, economic rules, and political rules. Informal institutions include tradition, taboo, reputation, norms of behaviour that are part of the ideology, and culture. (North, 1990)

Formal institutions are set by authorities at national level, it is mainly parliament and government or it can be delegated to other bodies that are either national or supra-national, such as the European Union. (Peng & Meyer, 2011)They are part of the political and economic system and are enforced by the state (i.e. police, judicial system). Enforcement is possible by means of sanctions for example imprisonment and fines. (Pejovich, 1999)When formal institutions are effective, informal institutions only complement them and are almost non-noticeable. (Peng & Meyer, 2011)Almost all aspects of political life are subject to formal rules. (Grzymala-Busse, 2010)

However, if there is a fail in formal institutions, informal institutions become an important factor in reducing uncertainties by offering direction and awarding legitimacy and compensations to companies and managers. (Peng, et al., 2009)

Informal rules are sometimes known as the hand of the past, the old ethos, or the carriers of history. They represent the society's fundamental understanding of the world, the stored knowledge of the previous, and an existing set of values. Informal rules are an important part of the culture and are continued from one generation to the next one through different transmission methods such as impression, narratives, and teaching.While the government enforces formal rules, informal are seen more as the rules of appropriate conduct and are not directly enforceable by the law, but outside of officially sanction channels. Their enforcement is possible for example by the use of exclusion from the community, ostracism by neighbours, or friends, or loss of reputation.(Pejovich, 1999)

Informal rules are not officially written down. They are different in different societies. Actors tend to perceive their own culture as only "natural, rational and morally right".

Then again, what is common in one society doesn't have to be common in another society. (Peng & Meyer, 2011)

Some literature takes formal constraints as a prior and given, however through history we have witnessed a lot of economies that failed due to bad economic rules that were not able to generate lasting economic growth. (North, 1991)

The impact of informal rules is mostly dependant on formal rules.

INSTITUTIONAL FUNCTIONS

Formal and informal institutions have different and important functions in a society, which directly determine the economic, social, and political behaviour of actors. In general institutions have a function "to facilitate exchange through predictable human behaviour in a world of uncertainty and incomplete knowledge. " (Pejovich, 1999)

Grzymala-Busse (2010) highlights three main functions of institutions:

> First is **resource distribution**. Examples of the formal institution doing this function are state welfare and taxation; and informal party funding, informal sanctions, power sharing, nepotism etc.
>
> The second function is the **source of information**. Stock reports, statistics are formal sources while reputation, gossiping, personal networks are informal and they could be used to decrease transaction costs.
>
> The third function is the **constraint on individual actions**, where formal are legal regulations and policing, while the informal example is monitoring or banishment. Informal arise for example when the state is not capable of enforcing property rights, private enforcers are expected to appear. (Grzymala-Busse, 2010)

INSTITUTIONS CLASSIFICATIONBY SCOTT

Sociologist W. Richard Scott provided another classification of the institution. According to him institutions containthree elementscultural-cognitive, regulative andnormativewhichgive stability and meaning to social life,together with associated activities and their resources.Therefore, he introduced a concept of three pillars that are crucial for supporting institutions regulative, normative and cultural-cognitive pillar.

The regulative pillar

In its widest explanation institutionsregulate and constrain behaviour. The regulatory function of the institution is the "capacity to establish rules, inspect others' conformity to them, and, as necessary, manipulate sanctions— rewards or punishments—in an attempt to influence future behaviour".(Scott, 2008, p. 52)Sanctioning may be through the informal and formal mechanism. Informal could be shunning or shaming, while formal are mainly through highly formalised instances like juridical system or police. Economists emphasise this pillar as the most important for institutions. (Scott, 2008)

The Normative Pillar

This pillar is based on the normative system that consists of valuesand norms. Values can be described as that what is wanted or favoured. Standards that are then constructed based on values serve as a parabola to existing behaviour. Norms outline goals and stipulate ways for achieving values. Some norms and values are valid for everyone while others only for certain categories of actors or positions. Thus,they grant right as well as responsibility and determine both privileges and duties, thereby establishing roles in society. Norms can be established by different groups, such as trade and professional associations.

Opposite to regulative pillar, violating of norms and values is not sanctioned with legal means. Infringement of norms bears with it a feeling of dishonour and remorse, whereas model behaviour brings afeeling of honour. Hence actors obey norms due to a feeling of social responsibility and the associated social prospects. (Scott, 2008)

The Cultural-Cognitive Pillar

This pillar stresses the importance of the cultural-cognitive aspect of institutions. Individuals attach meaning to the behaviour and to events, and external objects using a subjective representation of the world. Explanation to how will they react to external stimulus is influenced by this process. However, individual`s representation of the world is strongly influenced by culture and shared understanding or logic. Creation of these cognitive paths is largely unconscious, therefore taken for granted. If the individuals act in accordance witha shared understanding, they experience a positive feeling of confidence and connection to society, while acting out of dominant cultural beliefs individuals experience feelings of confusion or disorientation. Hence individuals' internal interpretive process is constraint by the external cultural framework. Although culture moulds individual belief system and provides rules how to think, feel, and act; individual concepts canchange belief systems as well. (Scott, 2008)Beliefs connected to culture frequently vary, sometimes they are challenged or disputed, and sometimes they are embraced only by some actors. (DiMaggio, 1997)

It is important to emphasise that in the most empirically observed institutional forms all three pillars are combined and observable at work.

According to Peng et al. (2009),although terms differ, North's approach based on dividing institutions into formaland informal is complementary to Scott's three pillars concept. (Table 1)

TABLE 1 DIMENSIONS OF THE INSTITUTIONS

Degree of Formality (North, 1990)	Examples	Supportive Pillars (Scott, 1995)
Formal institutions	Laws Regulations Rules	Regulative
Informal institutions	Norms Cultures Ethics	Normative Cognitive

SOURCE: PENG ET AL, 2009

THE INSTITUTION-BASED VIEW BY PENG

With an ever-increasing process of globalisation study of international business is gaining importance. Strategies that companies apply when dealing with this process will determine its success. Therefore, the most crucial questions of strategy management are: "What decides whether the company will be successful around the world?" and "What influences companies´ strategy in international business?" The importance of institutional framework has been established earlier in the thesis; institutions do matter and influence the behaviour of all actors in a society.Mike W. Peng dealt with this topic and the result was an introduction of the institution-based view of international business strategy as a supplement to existing views of strategic management. Peng was influenced by intellectual movement centred on new institutionalism, especially by Scott's three pillar approach and North's NIE to develop a new approach. Apart from external influences, he has discovered that existing industry-based and resource-based views are lacking context and that the third leg must be introduced in order to sustain a platform.(Peng & Meyer, 2011)

The industry-based view was developedin the 1980s by Porter (1980) and is based mainly on the patterns of competition in the U.S. It describes five competitive forces that model markets and companies' strategies. These forces define the intensity of competition and thus the profitability and attractiveness of different industries. These forces are:

1) Bargaining power of customers

2) Bargaining power of suppliers

3) Intensity of existing competitive rivalry

4) Threat of new entrants and

5) Threat of substitute products.

The problem with Porter's five forces model, which is centred on the rivalry, is the fact that itrarely asks what lies behind rivalry, and is ignoring the influence of formal government policies and informal institutions and context in general. Under specific institutional settings strategy of cost leadership can be seen as unethical or even illegal, especially in the international business environment, where this strategy can trigger antidumping masseurs. Also, the carrying out exclusively strategy of cost leadership in international trade has its shortcomings in ignoring the host country regulations and laws.

A newer approach, so-called the **resource-based view**,advocated by Barney (1991), asserts that the firm bases its competitive advantage on rare and valuable resources. This view tends to ignore context also, because the resource that is rare and valuable in one context, doesn't have to be in another.(Peng, et al., 2009)For example companies in transition economies may encounter resources shortages and obsolescence where a resource that was precious under a previous institutional framework becomes invaluable under the new market-based institutional framework. (Wright, et al., 2005)

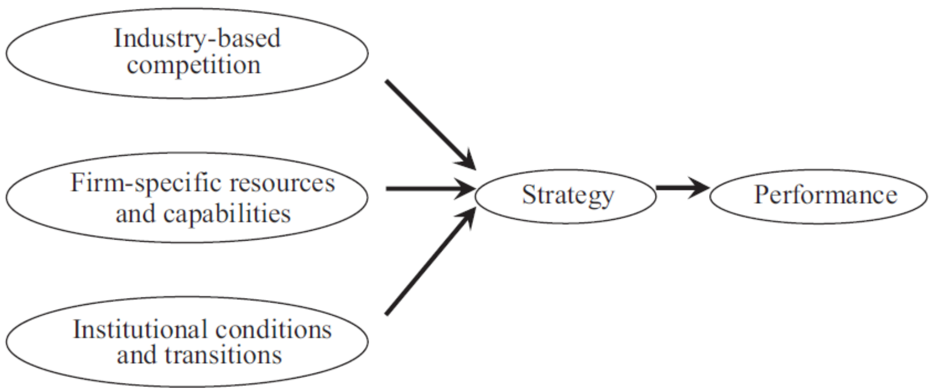
Especially with transition economies resource-based view overlooks important aspects: "the types of resources creating and sustaining competitive advantage vary across contexts both cross-sectional (such as developed vs transition economies, and Central Europe vs the former Soviet Union) and longitudinally (such as during the central planning era vs during the transition era)" (Meyer & Peng, 2005)

Often companies use established strategies on new markets such as first mover advantage to capture its potential. However sometimes, depending on markets and especially with emerging economies, in order to utilise such advantage, firms have to establish good relationships with governments. Sometimes company depends on domestic distribution mechanism. In essence, companies have to understand the correlation between their resources and institutional framework that is ignored in resource-based view. (Hoskisson, et al., 2000)

To overcome shortcomings of previous methods that were developed primarily in developed market economies, accordingly ignoring environmental peculiarities, the **institution-based view** was developed and is predominantly dealing withinstitutions. This approach views intuitions as the independent variable and concentrates on the dynamic correlation between institutions and organisations. The result of this correlation is the strategic choice that firm undertakes with a goal to create competitive advantage.

The industry-based view complements the existing ones and adds a missing legto strategy tripod. It is also emphasising that the choices that firms make are influenced not only by industry condition and company capability but institutional framework as well. Combining these three viewssustainable strategy tripod is formed. (Figure 15)

FIGURE 15 INSTITUTION-BASED VIEW



SOURCE: PENG ET AL. 2009

INSTITUTIONS IN EMERGING ECONOMIES

As already mentioned in the previous chapters, to better understand the role and importance of institutional framework it is necessary to analyse it, not only in developed economies surrounding but also in economies that are undergoing a process of intensive institutional change, so called emerging economies. Only then it will be obvious how important is the influence of institutions on development of an economy.

Emerging economies are those that are undergoing a process of rapid changes of the political and economic system, mostly directing it to free market system and use liberalisation as the engine of growth. They are characterised by the low incomeand fast growth and forwardness to open their markets and join trading associations. (Hoskisson, et al., 2000)Furthermore, they possess inefficient markets, huge business networking, and above average uncertainty, also government actively intervene. On the other hand, emerging markets create new opportunities for enterprises. (Xu & Meyer, 2013)

It is difficult to make precise classification of emerging economies Hoskisson, et al. (2000) divide them into two groups: economies in process of transition in the former communist block of Eastern Europe and China and developing economies of Latin America, Asia, and Africa. Although in later paperHoskisson, et al. (2013) states that emerging economies are not a homogenous group of countries, they differ and can't be that easily classified. An additional complication arises from the emergence of a group of mid-range emerging economies that cannot be classified either as the traditional emerging economy or developed economy. To tackle this problemHoskisson, et al. (2013) came up with classification into 4 groups according to their institutional development i.e. the development of market-supporting economic, legal, and political institutions and their infrastructure and factor market development:

1. Traditional emerging economies that are characterised bylow Institutional development and low infrastructure and factor development. Only a few economies belong to this group, unlike 20 years ago, when most of the countries belonged there.

2. Mid-range emerging economies, type 1 with low institutional development and high infrastructure and factor development. This group is reserved for mostof the former Central and Eastern European communist countries. They are characterised by dubious institutional development, but relatively developed infrastructure.
3. Mid-range emerging economies of type 2, which poses high institutional development, but low infrastructure and factor development. Poland is atextbook example of an economy where democratic institutions were established relatively fast after the break-upofthe Soviet Union and the process of liberalisation progressedrapid, but infrastructure development was not able to pick up the same pace. China and India could be classifiedto this group as well.
4. Newly developed economies that have high institutional development and high infrastructure and factor development.

(Hoskisson, et al., 2013)

The common denominator for emerging economies is that they don't have a long history of institutions supporting international investment.

With the increase of the importance of emerging countries, the institutional-based view dramatically gains on the importance in international business.

INSTITUTIONAL TRANSITION

Institutional framework is in a never-ending state of flux in both developed and emerging economies, whereas change is more extensive in later. The process of change to institutional framework is called institutional transition and was extensive in transition economies. A lot of emerging economies are going through the process of transition from planned economy to market economy. (Peng & Meyer, 2011)To explain transition first some basic understanding of the centrally planned economy is needed.

Planned economiesare based on central economic planning that has a role of the market and is supported by bureaucratic apparatus. Resources are allocated by state and formal laws defining exchange relations between different economic actors is not needed. Supply, demand, and pricing are also part of the plan. The government guarantees the property rights and assets are state owned. The central government develops the plan, but not exclusively, sometimes planning goes from base to top and is composed of targets that are then carried out by state owned enterprises (SOE). These companies are operating under soft budget constraints, they are provided with sufficient funding from government and indirect preferential treatment.Therefore, SOEs have little incentive to make profits, grow sale or develop new products. (Hoskisson, et al., 2000)

Never in history has one economy managed to achieve completely planned economy, USSR came close to it. Although today almost all countries have the market economy that is influenced by non-market forces, the process of transition from centrally planned to the market economy is still not finished in some countries. (Peng, et al., 2008)

Transition process includedweakening of central economic planning through establishing the market-based institutions. However,this process is slow and characterised by the emergence of problems such as the absence of the legal framework for property-rights, unstable political structure, and lack of markets wherein companies acquire resources neededfor the application of their product market strategies.Additional problem is that the formal legal framework isincomplete, volatile, and unpredictable (Peng, et al., 2008), since formal institutions are persistently being eliminated, altered, and established over. (Grzymala-Busse, 2010)

Volatility and uncertainties lead to rising in bribery, corruption, rent shifting and opportunism hence increased the role of informal institutions. (Hoskisson, et al., 2000)

Although it is easy to change formal framework with the political or judicial decision, informal constraints are more difficult to change, because they represent part of culture and habits. What is more, in an environment where formal institutions don't provide enough support for actors and don't reduce uncertainties, informal constraints play a larger role. Informal institutions provide certain consistency and certainty in times of major transition. (North, 1990)For example, in transition economies, organisational groupings such as business groups (conglomerates) and networks evolve as a substituted for formal market institutions. (Wright, et al., 2005)

Informal institutions mostly serve as substitutes for formal, but they can also influence the emergence of the formal institution by replacing them, for example, charity, undermining them (corruption), supporting or reinforcing them (reporting to formal authorities). (Grzymala-Busse, 2010) Sometimes informal rules may create precedents and widespread habits that are then formalised for the purpose of efficiency, for example,the upsurge of private property and the inclusion of capitalist entrepreneurs into the Chinese Communist Party. Though China expresses no wishes to make the transition to democracy, its economy has undergone considerable changes in formal institutional framework dealing with the private sector.(Tsai, 2006)

It is important to add that even in developed economies formal institutions form a small (but key) part of overall institutional constraints and informal rules arepervasive, hence play very important role. (North, 1990)In developed economies when a company can't follow the strategy of cost leadership or doesn't possessvaluable resource it can still achieve an advantage over the competitionin political, nonmarket ring, where informal constraints play a crucial role. For instance, by lobbying and use of networking. (Peng, et al., 2009)

CHARACHTERISTIC OF INSTITUTIONS

Emerging economies are the best playfield to test the impact of institutional influence on both economy in general and firms' strategies because their economies are still heavily regulated but in process of liberalisation. Institutions are mostly immature which results in increased costs of running business operations for companies.

Some of the challenges that emerging countries face in this respect recognised by Wright, et al. (2005) are:

- Lack of transparency, information asymmetry and high monitoring and enforcement costs make markets in emerging economies less effective
- Government and governmental structure participate actively in the economy through SOE or state-controlled enterprises.

- Network-based behaviour is widespread and affects interactions between companies, due to inefficient markets and social traditions.
- High risks, uncertainties are common because of the instability of political, legal, and economic institutions. Therefore, firms face difficulties when making strategic decision

This implies that, when dealing with emerging economies, common economic theories are not as applicable as the institutional theory. As predicted by Hoskisson et al. (2000) this theory has grown and turned out to be a new leading theory when dealing with emerging economies. (Wright, et al., 2005)Although the institutional theory is not a theory per se but set of different approaches that are based on NIE that tries to answer, "*how and why institutions matter*". (Xu & Meyer, 2013)

ENTERING NEW MARKETS

Applying traditional global strategy for entering the new markets, when dealing with emerging economies, may not be sufficient. The institutional approach must be applied so that behaviour of Multinational Enterprises (MNEs) could be better understood. Institutional theory is predominantly used in the business practice since the economic and political significance of emerging markets increased. There is a necessity for MNEs management to understand the rules of the game in a potential host country if they want to succeed. (Tihanyi, et al., 2012) MNEs could improve their competitiveness on the new emerging markets by using institution-based view approach, hence learning the rules of the game. (Peng, et al., 2008)

In his study Barnard (2010) observes that MNEs very often face the problem of host nation resource accessibility. MNEs are confronted with different expenses when entering markets in emerging economies such as organisational specific expenses, expenses with respect to longitudinal distance and expenses resulting from both host and home nations' institutional environment.(Barnard, 2010) Lu & Xu (2006) have also concluded that the acceptability of the vital resources is crucial for MNE's success and the institutions are those, which determine the level of acceptability. Thus, if this level is low, the costs of conducting business increase. (Lu & Xu, 2006)

Furthermore, MNEs which generally standardise services and products globally, when entering the new emerging markets, tend to ignorethe potential of the millions of new customers, and provide service only to wealthy few. (Dawar & Chattopadhyay, 2002)

Peng et al. (2008) discovered that India's exceptional growth in IT sector can be directly linked to institutional reforms performed by the Indian government in the early 1990s. Likewise, Go Global and Open-Door policies in China opened the door for Chinese extraordinary economic development in the past two decades.

It can be concluded that the role of the government in emerging economies tends to be significant ininternational business matters and that the governmental policies influence considerably the entry strategies of MNEs. (Hoskisson, 2013)

However, Xu & Mayer (2013) points out that there are different views of how institutions influence rational actors. First, through incentives agents and their strategic decisions are influenced by the institutions. Second, institutions indirectly influence transaction costs that arise from contract enforcement, partner search or information symmetry, which are directly dependant on the efficiency of markets. Inefficient market results from institutional voids and MNEs try to develop strategies or institutions substitutes to overcome this problem. Third, institutions regulate competition. Very often emerging economies are characterised by monopolies and the laws regulating competition on the market are either non-existent or not enforced. Fourth, potential institutional changes create uncertainties; therefore, MNEs must be highly adjustable to changeable rules. (Xu & Meyer, 2013)

CASE STUDY: CHINA

Our world is on the brink of new radical change in power balance. As already explained at the beginning of this thesis China is on the road of becoming world´s number one economic power and with the economic power comes political and military power as well. China, with its unique political and economic system, is the perfect playground for scholars to research institutional theory.

In turbulent 1980s mostly western scholars have hypothesised that only drastic political changes leading to a Western style democracy, such as those undertaken by Gorbachev in the Soviet Union can lead todrastic economic changes, however after collapse of the Soviet Union and rapid development of economy of China, this hypothesis was partially revised and it was acknowledged that economic progress can be achieved without political reform leading to Western democracy.In China,political leaders genuinely thought that the western style of democracy is not suitable for the country because it could bring chaos and even lead to the disintegration of China. However,both Western scholars and Chinese leaders agree that the political reforms are important for economic progress. Moreover, father of the modern China Deng Xiaoping claimed that political reforms are a condition for economic change.(Zheng, 1999)

The next part of the thesis will deal with the changes in Chinese society and try to explain source of the change.

BACKGROUND

If we want to understand China for what it is today and where can it be tomorrow, we must understand how the country has been seen throughout the history and explain a concept of Eurocentrism. According to the definition from Merriam-Webster Eurocentric means "centred on Europe or the Europeans; especially: reflecting a tendency to interpret the world in terms of European or Anglo-American values and experiences". (Merriam-Webster, 2016) This definition can beexpanded, where Eurocentric view "regards European culture as pre-eminent"(Oxford-Dictionaries, 2016). The Eurocentric approach tends to misinterpret world history and to overemphasize Western dominance and uniqueness and to represent the Western culture as the personification and fulfilment of universal values. Moreover, Western civilisation is represented as genuinely human and as the vertex of human attainment. European scholars have long time advocated for this Eurocentric approach to the world history, sociology and economy, without taking into account development of the other parts of the world and ignoring big powers, especially in Asia. According to the most important European sociologists of the modern era, such as Max Weber, or political economist Werner Sombart and Karl Marx, so called "Rise of the West" was the evidence of the European exceptionalism. More authors questioned the ideology of Eurocentrism, for example, Edward Said in his book Orientalism critiques said that European hegemony is based on the idea of superior European identity and culture. (Said, 1978) Also, Martin Bernal (1987) in his book Black Athena, claims that the Western culture, which is developed on Greek culture, traces its roots to Africa, thus ignoring the significance of other parts of the world, is bias. (Frank, 1998)

The phenomenon of Eurocentrism is based on modernism, movement, which arose in late XIX and early XX century in Europe because of the rapid development of European countries and societies on the wings of Industrial Revolution. Common mistake present in Western literature is that economic superiority, which is founded mainly on rapid industrialisation, can be applied for an entire period of modern history, not only on post-Industrial Revolution period. In recent years, a group of historians fronted by Andre Gunder Frank, Bing Wong, Ken Pomeranz and Jim Blaut have called into question this

Eurocentric model. They question the superiority of Europe of early modern time, claiming that Chinese living standard as late as 1750-1800 was on a pair to Western, that the markets performed more efficient than those in Europe, and that the agriculture production was more sophisticated and more efficient. (Duchesne, 2001/2002) Moreover, Balut states that XV or XVI century Europe didn't have and couldn`t have an advantage over the rest of the world because it didn't have superior, but the same modes of production as the others. (Frank, 1998)This is also can be seen if GDP is compared. (Figure 1)

Frank goes even further claiming that capitalism is not a product of West because the global market of early modern age was formed by Eastern countries, who were dominating it until the Industrial Revolution. Before the Age of Discovery Europe wasn't even an important player in the world economy, however, exploitations of the New World helped it in attaining a stable position within the Asian markets. According to him, not even discover of Americas shifted power entirely to West, although newly acquired wealth did make West global player. European used gold and silver discovered in Americas to trade it to commodities produced in Asia, especially China. Even then, Europe had a trade deficit with China because it had to import a significant amount of good from Asia because commodities produced in Europe were not competitive enough. Furthermore, timber from North America used for shipbuilding helped to make Britain the most powerful naval force of the modern era. Britain, also, built merchandise fleet and gained importance in the world trade. European "rise" was mainly based not on developed institutions, entrepreneurship, or technology, but on the use of money from the Americas. However, it helped make West dominant world power in the next centuries. Surplus from the trade, built on the goods from the New World, such as cotton or sugar, which was based on slave labour, European invested in new industrial technology, which eventually led to the Industrial Revolution. Coal, the most important raw material in this era, was closer to the big cities in Europe, which helped in the rapid development of European economy of the XIX and XX centuries. (Frank, 1998)

The country that established XX century dominance, especially after the World War II, both cultural and economic was the USA. The Industrial revolution and World Word II helped the USA to rise as a global player and the most important world power of the XX century and early XXI century. However, Frank states that the dominance of the Western civilisation is just temporary and that the West is standing on the shoulders of Asia and that Asia will eventually dominate Europe again. (Frank, 1998)

Eurocentrism is not only prevalent in sociology and history but also in geography. Example for this occurrence is that although Europe is not a continent it is regarded as such, a second more extreme example is that map drawn using Mercator projection, which is world standard today, makes tiny Britain look almost as big as India. (Frank, 1998)

Some other authors such as Duchesne (2001/2002) dismiss arguments of the sceptics stating that they ignore so much contra evidence.

Nevertheless, with the Industrial Revolution started European and Western economic hegemony, which lasted for two centuries, however, Western economic hegemony may be coming to an end as the Asian powers, especially China, are becoming important players and are starting to shape alternative international system. It may happen that the centre of the world economy is shifting to the east. Having this in mind, Eurocentric view of the world, history, and values could potentially cloud European understanding of the change of the contemporary world and by not understanding the process Europe is in danger of lacking behind. Therefore, to understand global trends unbiased approach of global changes and the role that China is playingmust be adopted. Having this in mind next chapter will try to explain the evolution of China from backward agrarian economy to the world powerhouse, and how truthful and current is Napoleon’s statement “China is a sleeping giant. Let her sleep, for when she wakes she will move the world.” (China Daily, 2014)

REFORMS IN CHINA

The People's Republic of China was founded in 1949 when CCP won the civil war and established a communist state with command, centrally planned economy. At that time, Chinese economy could be described as the capital-scarce agrarian war-torn economy. The solution to overcoming the poor state of the economy, Chinese leaders saw in developing heavy industry, modelled on the full-scale transplantation of the Soviet Union pre-war model. Developed heavy-industry in the early 1950s represented the "symbol of the nation's power and economic achievement". (Lin, et al., 1996)The starting pointfor China meant that almost 90 percent of the population was rural and industry accounted only for around 13 percent of national income. Theheavy- industry development strategy was carried outacross the Soviet based series of Five-Year Plans.

The First Five-Year Plan (1952-57), which was shaped partially in Moscow, was a remarkably successful project of economic development. The plan was based on the Soviet experience of industrialisation and collectivisation in 1928-1939. Assistance, based on the transfer of technology and know-how from the Soviet Union to China was crucial tothe success of the First Five-Year Plan. Around six thousand advisors helped in establishing and operating more than 150 large projects. Soviet-helped projects accounted for more than half of all investment in the industry during the First Five-Year Plan and represented the core of the program. (Cheremukhin, et al., 2015)

Reform in agriculture was successful as well, Cheremukhin, et al. (2015) explained the reason behind this success. First, agriculture didn´t represent merely a source of income for the forced industrialisation. Second, agricultural production started to use more advanced methods of production such as the use of fertilisers, better seeds, afforestation, increased multiple cropping and increased irrigation. Third, better distribution and consolidation of land plots, due to collectivisation, allowed more efficient use of mechanisation and travel time between plots was decreased.

MAO ZEDONG´S REFORMS

After the successful First Five-Year Plan, which was more technical and less based on ideology, founding father of the PRC Mao Zedong decided to push reforms even further. He wanted them to be quicker and more successful. To accomplish that already in the early 1950s he undertook intense political centralisation, under the pretence of establishing a centrally planned economy. Chairman Mao has almost monopolised decision-making process in the post-war China. Although the provincial-based structure was kept, regional leaders were promoted directly by Mao and some of them even physically moved to Beijing.(Xu, 2011)After establishing political dominance, Mao initiated socio-economic programs People's Commune Campaigns and so called "*Great Leap Forward*" (GLF),which lasted from 1958 to 1961.The aim of these programs was the development of agriculture based on land collectivisation, and rapid industrialisation, with the goal as he claimed of exceeding the industrial production of United Kingdom in 15 and the United States in 20 to30 years.In the next period supporting pillars of economic development were to be heavy industry and agriculture.(Yang, 2008)

INDUSTRY

Chairman Mao initiatedmassive investments in the heavy-industry sector. In general, development of this sector is characterised by very long maturing, up to seven years was a period needed for setting up a steel plant in China. Additionally, industrialisation is extremely capital-intensive undertaking and demands huge lump-sum investment.Also, almost all equipment in the first phase of industrialisation had to be imported from more developed countries, mainly the Soviet Union. At the same time China experienced capital scarcity, interest rates were high and the exchange rates due to the poor economy were low. (Lin, et al., 1996)

To tackle these problemsgovernment artificially lowered interest rates to reduce the cost of capital and overvalued exchange rates to ease import of necessary equipment for industrialisation. Additionally, input prices of transportation, energy, and raw materials, as well as workers’ wages were kept low. Low wages implied that the prices of medical care, housing, food, and other consumer goods, needed to be low as well. (Lin, et al., 1996)

The aim of this policy was to provide the industry with enough assets for reinvestment and reinvestment could only be guaranteed if the enterprises were under government control.Therefore, important private-owned enterprises were soon nationalised, although the early plan of CCP was to allow the private ownership even after the revolution. Because if the enterprises were privately owned, they were not obligated to reinvest in planned projects.(Lin, et al., 1996)

Traditional household-based industry in rural China also faced severe consequences of the GLF policy. In rural China household business, tiny, adaptable, and market-oriented production units thrived for centuries. Most households had a side-line occupation, the most notable was handcraft processing of agricultural goods and turning them into products for the market. However, in the centrally planned economy, all industry had to be part of the central planning and agriculture was forcibly separated from it. So, in the 1950s organic connection between growing crops and their processing was cut by the state. The government established a monopoly over the supply of agricultural goods, as consequence rural household production units were cut off from suppliers and their production declined. Additionally, the rural population was forced into agricultural collectives, further damaging the industrial production,consequently, rural China became increasingly deindustrialised. Eliminating households from a side-line income led to the severe decline in their prosperity. (Naughton, 2007, p. 272)

GLF didn´t bring significant results as expected, despite intensive investments in industry. Cheremukhin, et al. (2015) identifies three main problems. First, a breakdown of the agricultural production, which will be explained in the next chapter,led to the severe shortage of raw materials for food-processing and textile industry, thus harming its perspectives. Second, a lot of insignificant small back-yard production plants, e.g. steel production units were extremely inefficient. Third, split between China and the Soviet Union led to the departure of all Soviet advisors and put a halt on all projects that were in cooperation with the Soviet Union.

AGRICULTURE

Except for industry, in a focus of Chairman Mao´s reform was the agriculture, so under his rule, China initiated significant reforms in the agriculture sector. At that time, China´sexport was based on inexpensive agricultural goods, which represented 40 percent of total export and represented the only resource of convertible currency, implying that China's capacity to import expensive equipment for heavy-industry depended highly on export i.e. performances in the agricultural sector. (Lin, et al., 1996)Therefore, to support the process of industrialisation and to be able to provide cheap food for the urban population, the government initiated reforms in the agricultural sector.

The first step in agrarianreform was the further collectivisation i.e. establishment of people´s commune as primary agricultural production units. Although, at first voluntary participation in people's commune was gradually made mandatory. Consequently, the average size of the commune increased dramatically and most of them consisted of over 5000 members. Due to their complicated organisation and size, managing it effectively was extremely difficult and almost impossible. (Cheremukhin, et al., 2015)

Reforms also included abolishing of the private ownership of the land andwerealso used as the tool to fight the rich landlords. Although they compromised only 4 percent of the rural population, rich landlords owned 30 percent of the land and produced almost half of total agricultural production. Former landlords, together with poor peasants, were now forced to work on state-owned collective farms. Prior to 1958,peasants were participating in rural cooperatives on a voluntary basis and had the incentive to work harder because hard-working individuals could exit cooperative. (Yang, 2008)However, workers at newly collectivised farms didn´t have the incentive to work hard, although income, declaratively, depended on individual contribution to production, it was almost impossible to measure and control it. The problems with deficiency of incentive policy, where all monetary rewards were forbidden, contributed to extreme lower productivity. (Xu, 2011)

Another measure of agrarian reform was an introduction of compulsory procurement policy, which obligated peasants to deliveredpre-set amount of their yield, to the government at the pre-determined price.(Xu, 2011)

Agriculture was financially neglected from the central government. Although almost 80 percent of China's citizens were employed in the agricultural sector, that sector received sheer 7,3 percent of state investments during the First Five-Year Plan, at the same time investment in heavy industry accounted for almost 40 percent. So, entire sector was under-invested.(Lin, et al., 1996)

Consequences of the Mao´s GLF agrarian reform were fierce. In the first year after GLP started, China's grain output suddenly dropped by 15 percent, and in the next 2 years, food supply plummeted additional, to 70 percent of the1958 level. During that period, a notorious famine exploded across China, the largest in recorded history. According to different sources, number of casualties ranged from 16 to 45 million. (Yang, 2008)

This massive failure in central planning originated in overinvesting in the heavy industry while neglecting agriculture at the same time, and excessive grain procurement by the state that supported urban population left peasants without enough food for their need.

All these negative consequences led to abandoning the GLF – policy.

However, from an organisational point of view, these campaigns were not a total disaster. GLF was characterised by strong decentralisation of the economy.With it, China stepped away from the Soviet model and replaced the central planning with regional competition. Provincial governments were encouraged to rival oneanother and compete over fulfilling the plans. Governance over most centrally controlled SOEs was handed over to local governments. The central government also encouraged regions to experiment with different commune organisations and to try to find unique ways to organise production and collective life.(Xu, 2011)

Because of GLF, China had already created a huge number of fairly self-contained regional economies. This represents the unique feature and strongly differs from all other highly centralised economic systems. Despite all negativity, GLF was the stepping stone for the future development.

AFTER GLF

Tremendousfailure of GLF damaged Mao´s prestige. After the great famine, period 1962-1966 showed a little bit of improvement, thanks to the influence of pragmatists Deng Xiaoping and Liu Shaoqi. Already in1962, it was decided to abolish some of the policies that led to famine. In agriculture sector reform included measures such as: shrinking the size of people´s communes from 5000 to 20-30 households, reintroducing theprivate plots ownership, decentralisation of communal management, which had a goal to make the communes more efficient, and reintroduction of material incentives. Around 20 million workers were returned to the countryside. (Cheremukhin, et al., 2015)Although the situation was slightly better, these measures didn't manage to resolve chronic food shortages.

In rural industry, new "commune and brigade enterprises" were established. They were again linked with agricultural collectives and served as the support for them. This measure started a new wave of industrialisation. According to plan, "Five Small Industries" were to be developed included farming, hydroelectric power, chemical fertiliser, cement, and iron and steel production. They were fundamentally different from the traditional rural industry that was processing of agricultural goods. The "Five Small Industries", wasthe replication of big capital-intensive heavy industries, but only on a smaller scale. These small enterprises were left out of the central plan because they were seen by the central government as insignificant, low-tech enterprises, with an insignificant number of workers that serveda small number of local customers. Nevertheless, these enterpriseswere firmly embedded in local communities, while their revenues were very often used by local governments to support agriculture and finance public works. (Naughton, 2007)

CULTURAL REVOLUTION

It is important to mention “The Great Proletarian Cultural Revolution” or just “Cultural Revolution”, which started in 1966 and ended with Mao´s death. Cultural Revolution had an extraordinary significance for the politics of the country because it represented Mao´s return to power after the disaster of GLF. He launched it under pretence to stop the return of capitalism and to preservethe true socialism. However, the aim of it was to purge his political opponents, especially Deng Xiaoping and Liu Shaoqi, and strengthen his power. As the part of the Cultural Revolution, schools were closed and the big parts of China´s citizens were forcibly displaced, especially youth from the cities, to the countryside. Although very disruptive in social and political aspect, Cultural Revolution didn´t influence China´s economy significantly. Naughton (2007, p. 75) concluded that “From an economic standpoint, the Cultural Revolution was, surprisingly, not a particularly important event”.

In general, the 1960s and 1970s economic policies didn´t make a significant impact on the Chinese economy. With Mao’sdeath in 1976, his ultra-leftist philosophy died with him, and more pragmatic leaderscame to power.

Immediately after Mao´s death, Chinese politician commenced the massive plan to fix the economy and to stabilise the CCP. They started massive import of the western technologies, hoping that the “Great Leap Outward” will help. They have rehabilitated thousands of managers that were purged in Mao´s Cultural Revolution, returning them to their previous positions. However, this policy crumpled and China found itself again on the brink of a food crisis and economic collapse. China´s leaders were now convinced that holding the status quo cannot help and that the reform must be radical in order to get the country out of the deep socio-economic crisis it faced. (Brandt & Rawski, 2008, p. 94)

DENGXIAOPING´S REFORMS

In December 1978, Deng Xiaoping became the leader of PRC, at the Third Plenum of the 11th Central Committee. His rise announcedestablishing of famous *gaigekaifang*or "Reform and Opening Up" policy. In a highly politicised setting, Deng promoted a new focus for the CCP, economic reconstruction.Political reconstruction wasn´t priority for him, he even called Gorbachev idiot for wanting to change political system first. He evenpredicted that the Soviet leader “won’t have the power to fix economic problems and the people will remove him."(Radchenko, 2014, p. 177)

Deng, therefore, decided to concentrate on the economy and led China to the long period of political stability and relaxation. He also shifted the focus away from the military. Deng wasn´t an economist, hedidn´t manage economic policy ona day-to-day basis, but at the several crucial moments. Nevertheless, he was a successful politician, hands-off leader, generalist and manager, and his most successful undertaking was godfathering Chinese economic reforms. However, some critics, such as Naughton (1993) claim that Deng didn´t have a clear vision where China should go, therefore he supported and promoteda policy of non-intervention. (Gruver & Zhu, 2016)

Deng´s approach to reform was a bottom-up approach. Ideas came from the lower level governments and if they worked, they could be introduced throughout entire Chinese economy.

The most important reform was an introduction of various “responsibility systems”. The introduction of responsibility system fostered delegating ofeconomic decision-making. Decentralisation through responsibility systemswas proved to be successful. In praxis, it meant that day-to-day affairs in factories or at the farmsshould be a responsibility of managers or peasants and not the Party. The Party shouldn´t intervene, rather it should be concentrated on ideological and political affairs.(Naughton, 1993)

RURAL ECONOMY

Chinese politicians were obsessed with self-sufficiency in grain production, so agrarian reform became one of the tops of the list of priorities, especially after the fiasco with food supply and great famine of 1959. Additionally, in 1970s grain stock decreased and the number of grain-deficit households in China increased. China was again on the brink of new food crisis, so the long-neglected reforms in agriculture had to be undertaken. (Brandt & Rawski, 2008, p. 8)

Throughout centuries rural industry had the crucial role in the economy of China. Not only due to fact thatthe vast majority of China´spopulation was rural, but also because the development of countryside has always influenced China's overall development and during Deng´s reform it played the important role in thetransition from centrally planned to market economy.In general, the speed of transition in rural China determined the pace of reforms. A Chinese type of capitalism is essentially rural in its origin. (Huang, 2012)

The most successful measure in agrarian reforms was the introduction of responsibility systems **household-responsibility system** (HRS), which wasn´t introduced immediately at the beginning of reform process, but happened gradually. HRS meant replacing people´s commune and collective farming system with farming based on individual households farming to solve managerial and incentive problems that these communes were facing. However, at first, the government saw this reform as the step back in social revolution and a threat to socialist principles, therefore, they didn´t allow it. Nevertheless, several communes started with the practice of the leasing land to individuals and contracting other output quotas. At the beginning, it was done secretly and without the support of the authorities, later with the consent of the local authorities. Results that arose from this experimentation were overwhelming and HRS was gradually introduced in the entire country. Already in 1984, five years after the first experiment, 99 percent of all production teams were participating in HRS. (Lin, 1992)The government didn´t privatise the land. Farmers could only lease the plots on the long-term basis. HRS restored the connection between effort and reward, and that increased the productivity of the work and output so much that farmers even started to look for outside workers. (Brandt & Rawski, 2008, p. 9)

Decollectivisation of the land proved to be an important step in dealing with the food shortage problem and the first of the market-oriented reforms in the agricultural sector.

Another important aspect of the rural reform was price reform. A distinctive feature of China´s economic system was an existence of two different prices, **quota** and **above-quota prices**. Quota prices were paid by the state for the quantities of goods that were obligatory by the compulsory procurement and above-quota prices for the goods that are above this quantity, meaning that the farmers could sell above-plan goods at higher market prices. This represented an incentive for them to increase production. Already in 1979 quota prices for certain goods increased 17 percent and above-quota from 30 to 50 percent higher from the quota prices. The consequences were ambiguous production increased but at the same time prices of the retail goods increased as well. To compensate it, the government decided to financially subsidy urban population. However, the burden for state became too big when the production spiked and expenditure for subsidy increased from 8,4 percent to 24,6 percent of the state budget. To solve this problem government decided to abolish procurement obligations and introduced voluntary procurement contracts. Contracted price was to be calculated as an average between quota and above-quota price. For a peasant that meant around 9 percent decrease in price margin. Following years showed a decrease in production, and that motivated government to make contracts obligatory again.

An additional step to increase the market role was the reduction of the number of the products that are subject to the mandatory production plan. That increased arable area with cash crops, crops that brought higher profit margins to farmers, simultaneously grain acreage declined, what was compensated by grain imports. (Lin, 1992)

Agrarian reforms were thehuge and instant success. In the period between 1978 and 1984, per capita income in rural China increased by factor 2 between,while consumption raisedby 51 percent. In the same period,grain productionincreased to 407 million metric tons and it almost doubled compared to 1978. (Naughton, 2007)

All these reforms which increased the role of the markets and decreased the intensity of agricultural planning were made able through decentralisation and experimenting. The point of this decentralisation was to empower lower levels because those who carry responsibility should also have the authority and in that way to induce mobilisation of initiatives.(Naughton, 1993)

RURAL INDUSTRY: TOWNSHIP AND VILLAGE ENTERPRISES (TVES)

Deng´s “Southern Tour” in 1992, where he proclaimed the necessity for accelerated economic reforms and promoted endorsing of a “socialist market economy”, significantly influenced the development of the Chinese rural industry that was based on township-village enterprises.

Additionally, China’s economic success didn´t happen only because the productivity in rural China increased, but also because farmers change over to industrial and service segment.Township and village enterprises (TVEs)contribution was crucial in this process.Nonstatesector, particularly the TVEs grew instantly as the consequence of the deregulation of the resources allocation system.The first market-economy-like competition was among TVEs before private sector was developed and foreign firms were even allowed to conduct business in China. The rise of TVEsweakened the monopoly of SOEs both in production factor market and product market.(Huang, 2012)They increased ruralearnings, employed rural labour forcelaid off from farms, and at the end aidedin narrowing the gap between urban and rural China. Theeconomic transition in China was carried on the wings of rural transformation.

TVES ORIGINS

TVEs originate from the rural people´s communes that were created during the GLF. Under GLF policy communes were encouraged to set up small factories and engage in different service activities. However, due to severe miscalculations and bad management, almost all of them were shut down in the post-GLF period. After 1970, on their foundation new “commune and brigade enterprises” were established under pretence to “serve agriculture”. They have survived but at that timedidn´t have an important impact on the economy.(Naughton, 2007)

In 1982, after the name of communes changed to townships, and villages got their old name back, commune and brigade enterprises were renamed to township and village enterprises.

TVES IN PERIOD 1978-MID 1990S

The new policy from 1978 represented a return of rural industry to its traditional origin. The goal of the reforms was to restore broken link between agricultural production and rural industry, it was planned,whenever it was possible, to process agricultural goods locally in rural areas. This was the first time, after almost 30 years that the rural industry could engage in all activities on the market. Liberalisation of the monopoly on the allocation of agricultural goods quickens the development of TVEs, which soon became the most successful part of the economy.

SOEs monopoly was jeopardised for the first time and TVEs could now compete with former state monopolies. However, competition also pushed SOEs to increase productivity and introduce incentive policy that will foster development. TVEs became a motor of China´s transition process.

Between 1978 and 1996, number of workers employed in TVEs increased by 107 million. In 1996 TVEs contributed 26 percent of China´s GDP, in comparison with only 6 percent the year when the reform started. (Naughton, 2007)

Naughton (2007) recognised five favourable factors that explain the success of the rural industry:

1. **High adaptability to real factor-price of the Chinese economy**. Chinese economic reality in terms of production factor endowment was the abundancy of labour and land, and scarcity of capital. TVEs, unlike SOEs, didn´t have access to capital with state subsidised interest rates, so they were forced to acquire capital at the market interest rates. Other particularity, was that the wages in TVEs were up to 60 percent lower than those of SOE´s worker. Thus, to thrive and survive, they had to adapt and specialise in industries where they could use the competitive advantage of the low wages and where the capital intensity was low. They used economic fundamentals

of the Chinese economy to their advantage and engaged in a business that would give them an upper hand over competitors in the long run.

2. **TVEs became very profitable, byexploitingmonopoly rents made for the state enterprises**. Profitability of TVEs was remarkable. However, with the time more and more TVEs entered the market and competition pushed the profit rates down. SOEs also became aware of the increasing competition so they started to compete as well.

3. **The institutional framework surrounding TVEs was in favour of development.**Local governments were very enthusiastic about their development because they were often the only source of the money and employment for the local economy. Local governments supported TVEs with thelow tax rates, especially on profit, unlike SOEs that often had to pay 100 percent tax on profit. Formal tax rates were only 8 percentin 1978 but gradually rose to 20 percent. However, the local government kept around 30 percent of TVEs´ profit that they could classify as extra-budgetary revenues and were not obliged to share with the higher instances. Therefore, they were supporting TVEs and even reinvested some of those profits back into them. The local governments were also serving as the guarantors for TVEs by the financial institutions. Start-ups had an easy access to capital, the government helped in spreading the risks and local community took over the cost of failure.

   Increased supply of money from the local rural creditcooperatives (RCCs) also helped in developing TVEs. As the local household saving went through the ceiling, RCCs had a significant amount of money at their disposal that they could use to invest locally.

4. **Vicinity to urban accommodated growth ofrural industry**. TVEs located in suburban areas could use advantages of the rural positioning such as access to land and inexpensive labour. The proximity of urban areas allowed TVEs totake advantage of their infrastructure, communications, technology, markets, and they

could purchase talents from the cities. Additionally, many TVEs cooperated, mainly in form of subcontracting agreements with SOEs. SOEs benefited from cooperation with TVEs because it helped them to escape strict state supervision, and TVEs profited from this cooperation as well.

5. **Organisational diversity fostered growth**.TVEs, nowadays, are mostly privately run but only after the stigma of private property was lifted in the early 1990s. Before that, they were mostly collectives or government run enterprises. The fact that TVEs included a spectrum of different organisational form allowed them to be more resilient and more adaptable to changing conditions on the market. They were also flexible to exploit a wide range of opportunities.

Lin (1996) has recognised two unpredicted effects on the course of reforms that were produced by TVEs´ growth. First, TVEs that were significantly more productive, put the pressure on policy maker to apply TVE micro-management to SOEs and to allow them more autonomy. Second, development of non-state sector mitigated resource misallocation and misbalance in industry caused by overinvestment in heavy industry. Development of TVEs´allowed the entrepreneurial spirit of the Chinese came to expression.

TVES FROM MID-1990S

The period since the beginning of reforms in 1978 until the mid-1990s was the golden age of TVEs. However, with the change of macroeconomic policies, a shift in the reform strategy, and change in China´s economic environment created a more competitive environment for TVEs and drained some sources of niche businesses, TVEs fast growth ended.

Under the competitive pressure of thousands of TVEs urban companies were forced to adapt and to develop more efficient market responses. They engaged in niche businesses that were previously reserved, exclusively for TVEs and started to compete directly with them. This competition damaged TVEs who lost their sheltered special position in the Chinese economy. Competition rose demand for quality products and a lot ofTVEs cope with the outdated technology and low quality. Therefore, TVEs development stagnated from the mid-1990s, but TVEs managed to increased productivity because it wasn´t more feasible for them to employ more workers. (Naughton, 2007)

The competition was a crucial driver of institutional change. With an increasing discipline on financial markets, where banks were more risk and profit oriented, the local governments lost their ability and interest in being a guarantor for TVEs and bailing them out.Furthermore, in competitive environment managers appetites increased. They didn´t want to settle for mediocre compensation, so they demanded more. In public owned TVEs higher compensation was not an option. All this lowered interest of government for keeping TVEs in public ownership, so privatisation kicked off.Privatisation changed the nature of TVEs. For private owners, local unemployment levels were not important, and they didn´t employ more workers than they needed. TVEs gradually lost the role of absorption of the excess workforce in non-agricultural sector of rural China. However, private owners had the interest to keep the best managers and pay them accordingly.(Naughton, 2007)

Gradually TVEs transformed from the enterprises that offered support for the agricultural sector, and employment in rural communities, into resilient small enterprises, often connected into highlycompetitive industrial clusters, which specialise in the production of the single product. Clustering of a vast number of tiny highly specialised enterprises, countlesstownships and villages become what is globally known as a “world`s factories”. In one cluster thousands of small, often family enterprises, work together as one big integrated company. Although they work together, coordinating production and assembly of the certain products, they compete as well.

The clusters have support from the local government, mainly in providing good infrastructure, providing the regulations that will ease doing business, securing the property right, and workers education. Local government is not involved in a daily business of the factories, but they determine strategy, in the long-run, of the cluster. They act as theheadquarter of a conglomerate. (Xu, 2011)

The image of China as a “world´s factory” comes from the TVEs. The success of TVEs came spontaneous, induced by entrepreneur, bottom-up, as a response to overcome institutional weaknesses and constraints. Decentralisation of decision making, in this case, made it possible.

URBAN ECONOMY: STATE-OWNED ENTERPRISES REFORM

The success of the reforms in rural sector encouraged government to push the reforms further to urban industry. State-owned enterprises (SOEs) in Chinese command economy used to represent the backbone of very complex welfare system of urban China. SOEs offered life-time employment and included free medical care, housing, and pension to their employees. Additionally, they transferred profits directly to the state budget. They employed a large portion of the population, especially in urban areas, where 78 percent of all workers were working in SOEs. For their importance, gradual reform was favoured. (Ataçay, 2016)

Before reforms,the situation in state-owned enterprises was very gloom. Since profit hasn´t been quantification for success, and in centrally planned economies the goal is to supply state prescribed quota,SOEs were very inefficient. Allocation system of material goods was, planned and very inefficient, and often failed to deliver materials needed in the production process in time. Therefore, managers had the incentive to keep high stocks of raw materials but didn´t need to rationalise and use them efficiently. Executives didn´t have authority over determining employee earnings and rewards. Work effort hasn´t been connected to wages, therefore workers didn´t have the incentive to work harder. (Lin, et al., 1996)

To overcome this technical and allocation inefficiency government took the similar approach as in rural industry.

SOES REFORM 1979-1984

The first step in reforms was to intensify decentralisation by expandingthe autonomy ofSOEs during the 1979-1984period.

Reforms allowed SOEs to:

- retain profit and use it for investment or to allocate it for bonuses
- select the mix and level of production
- go on market where they can sell their products and acquire
- to freely set prices of “out of plan” output(Wu, 1997)

Because SOEs were permitted to produce outside the mandatory plan and to determine the prices for above the plan quantities, they had the incentive to increase production and productivity as well. More production increased drastically demand for raw materials., so the government decided to use the same approach for this sector as well. The production of raw material was deregulated and only some key under state control.Liberalisation of the resources allocation system promptedthe sturdydevelopment of the non-state businesses in this sector. (Lin, et al., 1996)

SOES REFORM 1984-1992

In the phase,1984-1992 SOEs were exposed to market influence and they gained more authority in export-import affairs, as well as the possibility to form mix-ownership, through different types of horizontal integrations, such as joint ventures (JVs). (Wu, 1997)With this measure,the non-state sector was strengthened further. For China, a new type of enterprisesemerged in a form of foreign-controlled businesses (FCBs). In these enterprises, foreign partner usually contributed with the know-how, technology, equipment, and experience in managerial and marketing affairs, while domestic partner provided guanxi (personal connections), buildings, and land. (Ralston, et al., 2006) Unlike SOEs, FCBs had the disadvantage that they had to procure raw materials, as well as other production factors only on the free market, where they were selling their products as well. In general, the entire non-state sector has conducted its business in the market environment so their managers had to be more resilient. Employees were not protected and could be fired, so the productivity was higher. (Lin, et al., 1996)

Exporting firms could retain a certain part of the foreign exchange at their disposal.

In the same year,the governmentintroduceda dual-price system for industry, as well, with a goal to help to increase the productivity of the SOEs. SOEs could sell products above the plan quota to market prices what stirred “grow out of plan”. (Lin, et al., 1996)

To further expand SOEs autonomy and create incentives to increase productivity, the government decided to reduce obligatory plan allocations and to introduce tax instead of profit retention, for large and medium SOEs. (Wu, 1997)SOEs also acquired authority to define wages and rewards to the workers.

A crucial part of the reform was an introduction of the Contract Responsibility System (CRS),that allowed private persons or groups to contract managing of enterprises. CRS meant that percentage or exact part of a profit from an SOE would be transferred to the government for getting a certain level of operative autonomy. Different from rural reform where HRS happened spontaneously, the state initiated responsibility system in SOEs.(Lin, et al., 1996)While HRS accomplished the elimination of collective farming and at the same time influenced the development of a free market of land in China,CRS didn´t spark privatisation of the Chinese industry.(Ataçay, 2016)

The goal of the CRS was to try to make SOEs earn higher profits and deliver more money from the taxes to the state. The CRS introduction meant further embracing of the market economy and abandoning the ways of centrally planned economy. However, in time, the CRS turned into a sort of subsidy system, because the Chinese government kept accountability for the SOEs deficits. Nevertheless, CRS represented an important step in decollectivisation of the Chinese industry. (Ataçay, 2016)

SOES REFORM 1992-2003

In thethird phase,1992-2003economic reforms have gained push, driven by additionalliberalisation drawn during Deng’s Southern Tour speech, and after the party leaders at the Fourteenth Party Congress embraced the concept of socialist market economy. Unlike previous reforms, that happened more spontaneously on bottom-up principle,through uncoordinated regional experiments, this reform was coordinated and centralised. Chinese government resolvedto distance itself further from the socialist system. They have decided to destroy old welfare system based on work unit system, so called "iron rice bowl", that guaranteed life-time employment, housing, medical care, and pension. (Ataçay, 2016)This approach to economy produced that the Chinese state-owned companies were overstuffed. The State Economic System Reform Commission estimated that overstuffing in SOEs was 30 percent of all workers in a state sector. (Lin, et al., 1996)The first moveto handleSOE´s overstaffing issuewas laying off tens of millions of SOEs.In 1997 22,5 million workers lost their jobs.Positive circumstance is that employing in private sector partially mitigated the problem of increased unemployment and absorbed a big number of laid off workers. Consequently, a labour market was formed, the concept of life-time employment in SOEs was abolished and it was substitutedwith a contract system. (Ataçay, 2016)However, even though the managers of SOEs could dismiss the employees, they didn´t exercise this merit very often because laid off workers due to the absence of welfare system were reduced to organising the protests to overcome their existential issue, hence they could cause social and political instability in China. Therefore, theoverstuffing problem was not quite solved. (Moore & Wen, 2006)

Another big issuethat was facing SOEs waspoor profitability. Near 40 percent of SOEs produced losses in 1995. Cumulative loss rose to 83,1 billion yuan in 1997 from the 5,4 billion yuan in 1986. The fact that SOEs carry a great social responsibility to provide benefits for workers and society in general, createda heavy financial burden for them. Additionally, SOEs faced inadequateincentives for reinvestment in new equipment and in technology, and for developing of workers and business executives. (Moore & Wen, 2006)

In order to overcome these issues reforms were undertaken under the slogan “grasping the large, letting the small go”. Large and medium-sized SOEs were to be reconstructed, while small inefficient and unproductive SOEs were planned to be closed, merged, or even privatised. Privatisation, in this case, differs from privatisation in former communist countries, which based their privatisation on selling successful companies, because China privatised small and medium enterprises and the large ones only if they were performing badly. (Ataçay, 2016)Because of these reforms number of SOEs decreased sharply. By 1997 around 70 percent of small SOEs were privatised and remaining SOEs drastically improved their profitability. Nevertheless, many SOEs didn't survive;only in 2001 more than 10000 SOEs disappeared.(Wang, et al., 2009)

As a consequence of the "grasping the large, letting the small go" policy, the SOE partof total industrial output sunk gradually, from 77 percent in 1978 to just 33 percent in 1996. (Naughton, 2007, p. 300) However, a lot of SOEs transformed to joint-venture corporations and the share of JVCs rose to 42 percent in 2004 as it can be seen in Table 2.

TABLE 2OWNERSHIP COMPOSITION OF INDUSTRIAL OUTPUT

	1984	2004
SOEs and corporations controlled by the state	49.6	38.0
Joint-venture corporations	6.4	42.1
Foreign-invested enterprises	24.7	30.8
Collective enterprises	19.6	5.3

SOURCE: NAUGHTON (2007) P.303

In Table 2 we can see that despite the reconstruction of SOEs and "letting small go" policy importance of SOEs for Chinese economy remained significant.

Reforms of the urban industry started to reshape China´s industrial sector. An important consequence of the reform was emergence and strengthening of the private sector. Only after 1997 privately-owned enterprises (POEs) became an important part of the economy, and two years later their existence was incorporated in the Chinese constitution. (Ralston, et al., 2006)

In light of privatisation, China decided to set up the national tax bureau and introduce of the unified tax rate, for all enterprises no matter of their ownership structure. This measure alsosimplified doing business in China.

SOES REFORM 2003-ONWARDS

The last phase of SOEs´ reform (**2003-onwards**) didn´t follow the same logical path of further privatisation, but opposite, state consolidated and strengthened ownership in for them strategic sectors such as the production of raw materials, banking, petrochemical, and telecommunication. Not only that, but the government continued to provide SOEs with subsidies and high bank loans. Despite reforms, that were proven to be a difficult task, SOEs continually suffer from increasing debt, inefficiency, and alleged corruption. (Ataçay, 2016)

Nevertheless, the study from Ralston, et al. (2006) concludes that, due to reforms, from organisational culture point of view, traditional bureaucratic and hierarchical structures of SOEs have evolved into more market-oriented forms. They implied that SOEs are on the path to grow into viable, world-competitive enterprises.

Since 2007, SOE reform started to stagnate and even regress. The challenge Chinese government was facing is to make SOEs globally competitive and dynamic, more like Japanese keiretsu or South Korean chaebols and less like the relics of China´s economic past.

The Third Plenum of the 18th Central Committee held in 2013 revived the reform and set an agenda to improve the performance of SOEs. The focus was on promoting mixed ownership in the SOEs, arguably a new expression for partial privatisation,only SOEs involved in the production of military and public goods were to be exempted of it. However, scepticism arose about the reach of the new reform and need for it. The goal of the previous reforms was to enable SOEs to be able to function under market economy both domestic and globally and that was more-less achieved, and China became integrated into the global economy. So, the mass privatisation was never part of the agenda. Additionally, the fact that SOEs today are making money, unlike in 1992, and ideological view by some conservative CCP members socialist state must own "means of production", doesn´t increase outlook for the reform progress. So, the presumption is that in the future SOEs will keep an unchanged position within the Chinese economy.(Ataçay, 2016)

The conclusion can be drawn, that after nearly40 years of the reform SOEs don´t dominate China´s economy anymore but they remain their important part.A major consequence of the urban industry reform is abandoning of egalitarian principles through the destruction of the traditional welfare system with an abolishment of the work unit system and the “iron rice bowl”.A side-effectof the reforms was also birth and rise of the new Chinese capitalist class and thereby deepening of social inequalities.

TABLE 3COMPARISON OF STATE-OWNED ENTERPRISES AND PRIVATE ENTERPRISES IN CHINA

	Number of Enterprises (Percentage of Total Enterprises)		Total Assets (Percentage of Total Assets in the Industry)		Total Profits (Percentage of Total Profits in the Industry)	
	State-owned Enterprises	Private Enterprises	State-owned Enterprises	Private Enterprises	State-owned Enterprises	Private Enterprises
1998	39.2	6.5	68.8	1.4	36.0	4.6
1999	37.8	9.0	68.8	2.0	43.6	5.3
2000	32.8	13.6	66.6	3.0	54.8	4.3
2001	27.4	21.2	64.9	4.4	50.5	6.6
2002	22.6	27.0	60.9	6.0	45.5	8.5
2003	17.5	34.5	56.0	8.6	46.0	10.3
2004	12.9	43.2	50.9	11.0	45.7	12.0
2005	10.1	45.6	48.0	12.4	44.0	14.3
2006	8.3	49.6	46.4	13.9	43.5	16.4
2007	6.1	52.6	44.8	15.1	39.8	18.6
2008	5.0	57.7	43.8	17.6	29.7	27.2
2009	4.7	58.9	43.7	18.5	26.9	28.0
2010	4.5	60.3	41.8	19.7	27.8	28.5
2011	5.2	55.5	41.7	18.9	26.8	29.6
2012	5.2	55.0	40.6	19.9	24.5	32.6
2013	5.2	55.3	39.4	20.0	22.2	30.5
2014	5.0	56.6	38.8	22.3	21.3	34.6

SOURCE: CHINESE STATISTICAL YEARBOOK, NBSC, 1999-2015

OPEN DOOR POLICY AND SPECIAL ECONOMIC ZONES

Deng´s philosophy that supported cooperation with outside world and his admiration for foreign success, especially that of Japan and South Korea, helped in promoting open door policy. Deng wasn´t being defensive when it comes to acknowledging of foreign performances and he taught that China can learn from foreign successes.Deng even supported and encouraged political reforms if their goal was to support economic reforms.

Up to the late 1970s, China practically didn´t have foreign investments,andthe foreign trade has been almost non-existent. As a part of "Open door policy" China´s State Council decided to allow a small-scale experiment in the distant coastal provinces Guangdong and Fujian. Four cities were chosen Xiamen, Shantou,Shenzhen, and Zhuhai.Experiment meant establishing the first Special Economic Zones (SEZs) in above-mentioned cities.

SEZs are special areas that are characterised by a set of rules and laws that are not valid for the rest of the country. SEZs are the result of the ``one country, two systems'' policy. The purpose of this policy was to experiment with the market economy and to test different measures that originate from market environment, on the small-scale. In the case that the experiment fails, the negative consequences would be contained at the small experimental area. However, if the experiment was successful the new ideas from opened market environment could be then introduced to the rest of the country if applicable. An additional objective of these experiments was to overcome all drawbacks and all negativities that arose from the central planning system. This tool had an aim to adapt Chinese economy in a step by-step manner and to shelter it from the big-bang effect that Eastern European countries faced.

Wang (2013) underlined four principles for SEZs:

1. Development of SEZs is based primarily on attracting and utilising of foreign capital
2. Wholly foreign-owned enterprises and joint ventures between Chinese and foreign companies are preferable forms of enterprises
3. Production is export-oriented
4. Free market

SEZs were intentionally opened in isolated areas to minimise possible negativeconsequences to the economy as a whole. These areas at that time were backwardagricultural communities, without any significant resources, weak industrial base, without skilled labour. The only advantage was the proximity of rich neighbours Taiwan, Macao, and Hong Kong. Thanks to the central government financial injection this changed. The first step was to improve infrastructure and facilities of SEZs and to establish a legaland administrative framework that would foster foreign investments. In a short period of time, the policies that were investor friendly attracted a vast amount offoreign and domestic capital. (Ge, 1999)

Encouraged by the initial achievement of SEZ experiment in four coastal cities, the central government decided to adopt regional laws used in these areas and expand it to other provinces. Law included the crucial regulations that could protect foreign investments, such as:

1. **Protection of private property rights.** SEZ will guarantee the protection of investors´ assets, accumulated profits, and other rights. This commitment from the

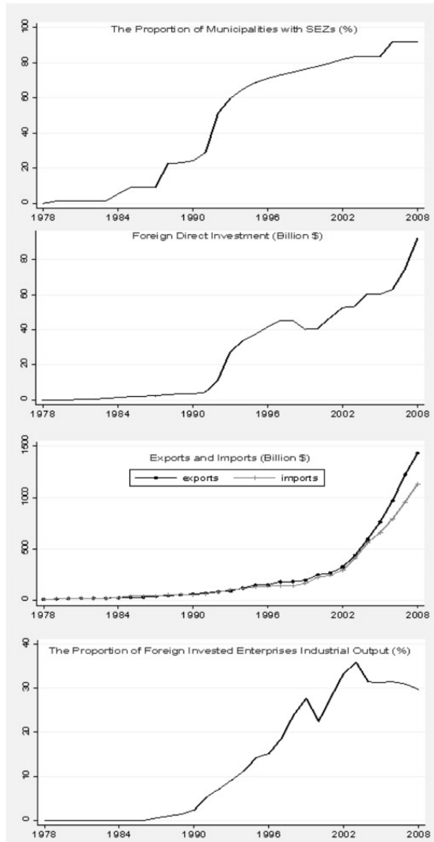
Chinese government was very important because private property rights didn´t have constitutional protection until 2004. This move had a goal toreassure foreign investors to enter China´s market and invest their assets in the own business.

2. **Tax and custom incentives**. Foreign investors enjoy no customs and corporate income taxes are lower than for the domestic firms. Also, foreign workers didn´t need to pay income taxes.
3. **Land use policy**. Private property over land in China was not possible under their civil law. To protect investor rights, government guaranteed investors rights on land use and development for business purposes. They could mortgage, lease, or even transfer land rights to other subjects. Financial incentives and exemption were also used to fostered investment.

SEZ contribution to the development of Chinese economy was tremendous. SEZs have created a vast number of new and better-paid work places. Increased productivity helped in efficient utilising of human capital, natural and physical resources. Export, trade surplus, and foreign exchange spiked. Tax revenues from SEZs were impressive. (Ge, 1999)

Figure 16shows explicitly the considerable relationship between the establishment of SEZs and foreign trade, investment, and the share of foreign enterprises' industrial output in China.

FIGURE 16 SEZ ESTABLISHMENT CORRELATION WITH FDI, EXPORT-IMPORT, % OF FOREIGN INVESTED ENTERPRISES´ INDUSTRIAL OUTPUT



SOURCE WANG (2013) PP 134

Thanks to the introduction and development of SEZs China became the leader country in attracting FDI. Already in 1985, some 37 percent of all FDI had it a destination in SEZs. While almost 90 percent of all Chinese export came from SEZs. 20 years later 95 percent of FDI and 95 percent export could be assigned to SEZs. (Xu, 2011)

Ge (1999) has recognised the most important positive effects that spilt over from SEZs across the entire country.

SEZs demand for raw materials, consumer goods, services and component parts were provided by the enterprises from the rest of the country. This led to the **employment and resource utilisation**. Development of SEZs led indirectly to the development of the rest of the economy that would otherwise not be possible if the SEZs weren´t that successful.

Employment increased directly in the enterprises that were cooperating with SEZs and through the employment of the rural population in SEZs when demand for labour force increased.

Another benefit was a**transfer of technology** from SEZs to inland companies. Because a lot of inland enterprises were the subcontractor for companies from SEZs, technology transfer was possible and abounded. Also, a rising number of joint-ventures established jointly by SEZs and inland companies increased this trend.

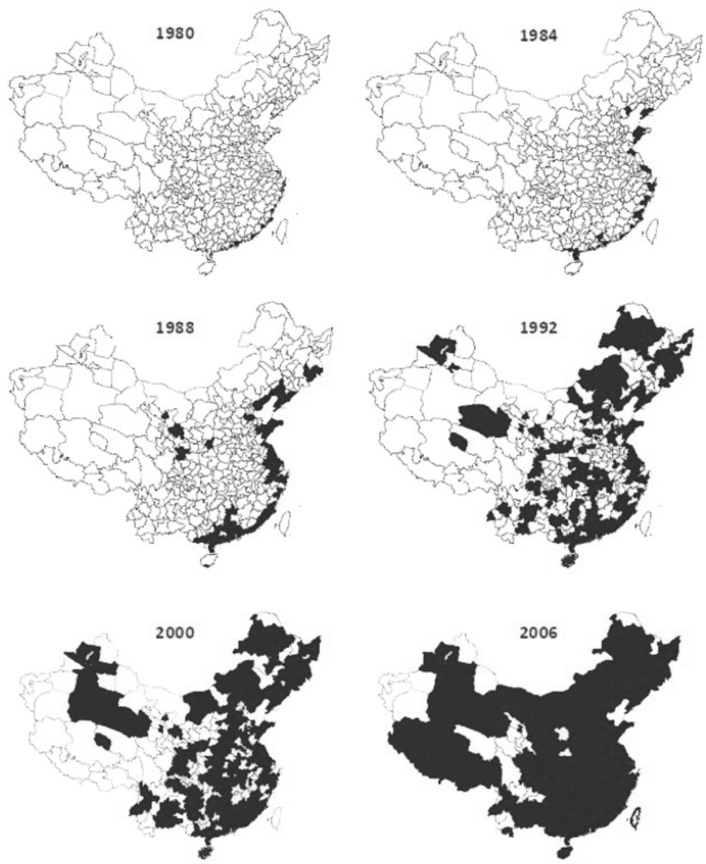
Domestic firms used well-established SEZs´ trade network and their know-how to **expand trade**, export to the world market. SEZs became intermediator between the world and domestic companies.

Furthermore, SEZs were a **source of economic reforms** for the rest of the economy. Successful measures experimented in SEZs were later introduced into the entire economy.

Encouraged by the success of the SEZ experiment, the central government decided to expand the experimentation in 1984. Additional fourteen coastal cities were included in the project. The process continued in the next years, up to 1988 more coastal municipalities were opened for investment from outside China, in 1990 the Pudong New Zone in Shanghai and the cities in the Yangtze River valley joined. In the next stage from 1992 to 1994, all the capital cities of the autonomous regions and inland provinces, along with several border cities opened. Additionally, 1346 province-level and 222 state-level economic zones were slowly created. The share of the municipalities with SEZ rose from 9 percent in 1978 to 92 percent in 2008. (Wang, 2013)

Figure 17 displays the spatial distribution of SEZs in China. First SEZs were opened in the more developed coastal area because it was important to provide them with better infrastructure, such as roads, harbours, airports, and telecommunication network. Later, experiment expanded toward underdeveloped inland. Newsday almost entire China is SEZ.

FIGURE 17 GEOGRAPHICAL DISPERSION OF SEZS AND PROGRESS OF THE SEZ EXPERIMENT



SOURCE: WANG (2013)

INSTITUTIONAL CHANGES IN CHINA

From the chapters above and the history of Chinese reforms, it can be concluded that unique feature of the Chinese reform is economic change by trial and error. Reforms were mostlyincremental. Different policies would be implemented and if they succeeded they would be legitimated and expanded to the whole economy.

Another important aspect was decentralisation. The central government introduced decentralisation, and lower level governmentscould perform institutional reforms as well.If these reforms were proved to be in line with the central government policies, they would be detained and accepted, if not they would be constrained.

Reforms, in general, can be reactive, those who arisebecause of changes in society or economy, or proactive, designed with a goal to achieve economic changes. They could also be initiated by the central government, or just legitimated by central government and initiated from below. Reforms in China are mostly institutional modification, mainly adjustment to new economic reality. The main characteristic of Chinese institutional system is the constant adjustment to the changes in society with a goal to sustain political stability and provide further economic development.(Zheng, 1999)

SEPARATION OF ENTERPRISES AND THE GOVERNMENT

Zheng (1999) recognised that in the 1980s Deng implemented two separations reforms. Separation of enterprises from government and the second separation of Chinese Communist Party (CCP) from the government.The goal of latter separation was reduction of interfering by the CCP in government matters, and to institute a more efficient government.

The formerseparationstarted as a legitimation of some characteristics of the market economy that was already in place in practice. The process was gradually initiated in 1982, where market economy for the first time, since the establishment of People Republic of China (PRC) was acknowledged as a supplement to planned economy. This separation was declarative finished only in 1992 on Fourteenth Party Congress when the market economy became part of CCP ideology. In practice, this meant that the government delegated its power to market, what is directly in conflict with the rudiment of planned economy.(Zheng, 1999)

CENTRAL-LOCAL RELATIONSHIPIN CHINA

The central-local relationship in China played an important role in reforms and it also greatly influences economic development. Zheng (1999) even claims that, unlike prevailing opinion in West, local governments rule China and not the central government. Therefore, the central-local relationship is very delicate and needed to be reformed with a caution.

In the late 1980s, communist countries undertook reforms to cope with a worsening economic situation. While the Soviet Union and Eastern European countries started reforms from "above", China under Deng's leadership took a different approach by initiating the process of rapid decentralisation of economic decision-making.However, after initial success in some regions, this process produced problems in the central-local relationship by unfolding economic localism and creating regional disparities. In the 1990s, as a consequence, China again entered the process of gradual recentralisation by strengthening the role of the cadre management appointed by central government. Central government introduced cadre transfer system, which helped to tighten control over local officials. (Zheng, 1999)

TAX COLLECTION

Until1980s, tax collection was highly centralised in China. Although local governmentsoversaw tax collecting, taxes were transferred to the central government, which then decided on its distribution back to local governments in accordance with their requirements.Same as in other areas Deng's reforms introduced decentralisation of the fiscal system. Decentralisation also meant that each local government was treated separately. (Pan, et al., 2016)However, the decentralisation increasedthe fiscal inequality and shrank central government revenues. (Zhang, 2006)

Faced with decentralisation problems, Deng didn't want to go back to the old ways by initiating the process of complete recentralisation, so he introducedso called selective centralisation. The most important reform, in this aspect, was introduction of central taxation system and system of shared taxes. Taxes were no more jurisdiction ofthe provincial government, rather national taxation office was established, which collected taxes and then divided them according to the previously established contract between local and central authorities. (Zheng, 1999) Contracts between central and local government included division of taxes between them, either by defining lump-sum payment or share. Every three to five years, contracts were revised and if extra revenues, beyond contracted plan, were reached, local government could keep almost all of it. (Zhang, 2006)

Parallel to the national tax office, local tax offices kept jurisdiction over local taxes. This reform helped central government to increase control over provincial governments using the fiscal systemand to boost its revenues also. (Zheng, 1999)

CENTRAL BANKING SYSTEM

Similar but with ambiguous results happened with reform of central banking system.The highly decentralised banking system of PRC was consisting of local central bank branches, which were under the influence and direct control of local governments. The central government as a part of the efforts to regain control over the central banking system and decrease economic localism, changed procedure of appointing of bank personnel, which were to be delegated directly from central office and not by local officials. However, despite reform, personnel were still under strong influence of local governments and promoted local interests. Therefore, new reform was proposed, all 31 provincial branches were to be eliminated and 9 regional branches, freed from the local influences, were to be established. (Zheng, 1999)

At the beginning of the process of decentralisation in China, it was not obvious whether it solved economic troubles or made them. However, one was clear, in China'scase, when there was a strong centralisation in place, economic incentives for local level were absence, but when the decentralisation took over, national policy was jeopardised.

This decentralisation paradox was solved by the mid-1990s with the continuous process of institutional adjustment, which had a goal to handle local-central relationship challenges. So, it can be concluded that incremental reforms both institutional and economic, helped China achieve significant economic growth.

PARADIGMOF CENTRAL-LOCAL RELATIONSHIP

We must keep in mind institutional economic model that assumes that the main goal of state officials is to maximise revenues for financing state functions. Government is doing it by maximising base from where they are collecting revenues. However Whiting (2000) recognised three types of constraints that unable revenue extraction.

First constraint is transaction cots that the state is facing when collecting revenues. Those are costs of enforcing performance, monitoring behaviour, negotiating agreements, and the costs of gathering information. In this context, the most important transaction cost is cost of determining tax base.

The second constraint is the ability of state to control tax collectors and their opportunistic behaviour. Interest of tax collectors and the state do not correspondent completely, if not controlled they may end up collecting revenues but keeping it for themselves.

Third constraint is inability of state to pursue policies that alienate key constituents. (Whiting, 2000, pp. 19-20)

Having this in mind we research central-local relations, which is crucial for explaining China's rapid economic development. After the first Deng's reforms in China, it was debated, whether the process of centralisation or decentralisation is responsible for economic problems that China faced in the 1980s. By the mid-1990s China resolved this paradox with the help of institutional reforms and reform of central-local government relations. There are three different paradigms, which try to explain Chinese economic success regarding the central-local relations. They are based on centralisation and decentralisation matrix. (Figure 2)

FIGURE 18 PARADIGMSMOF CENTRAL-LOCAL RELATIONS

Economic Centralisation (EC)	Political Centralisation (PC)
Economic Decentralisation (ED)	Political Decentralisation (PD)

SOURCE: (ZHENG, 2005)

THE MARKET-PRESERVING FEDERALISM PARADIGM, OR FEDERALISM CHINESE-STYLE

The first paradigm, which tries to explain reasons for significant economic growth in Chinais called the market-preserving federalism paradigm, or federalism Chinese-style.Barry Weingast, Gabriella Montinola, and Yingyi Qian were the scholars who introduced this paradigm. According to them federalism in China, whichis based on**economic decentralisation** (ED) is crucial for economic growth. ED created an institutional framework that guarantees economic progress, which is based on market economy. ED is aprocess of transferring of economic decision-making from central to local governments.As stated before, certain economic decisions were transferred to local governments, but unlike Eastern European countries, economic decentralisation didn't lead to mass privatisation and the property rights stayed indirectlystated controlled, in a form of township and village enterprises (TVEs). Different than state owned enterprises (SOEs), which were controlled directly by central government, TVEs were owned and controlledby local governments. Although central government lost its direct control over some enterprises, which is one of the main characteristics of planned economy, this didn't lead to the democratisation of political system, which stayed highly centralised. (Zheng, 2005)

The process of economic decentralisation in China is called **intergovernmental decentralisation**. Unlike Western governments, Chinese central government doesn't face election constraint, nor separation of power, however, Chinese style of federalisation ensures that the power is not concentrated in one governmental body, but divided among different levels. The main characteristic of Chinese-style of federalisation is that it inducescompetition among local governments so called **interjurisdictional competition**. Competitionis fostered by incentives provided by central government. A positive set of incentives rewards economic success, while negative punishes economicfailure. Since expenditures of local governments are directly and intentionally dependent on the revenues they generate, it is more probable that they will render sounder economic moves, because bad decisions carry financial consequences to them. Incentive systemestablished by central government inevitably steered economic development and growth of local communities.(Zheng, 2005)

The central government also created a benchmark competition among local officials by punishing or rewarding them based onthe economic performance of their local area. They also use an internal political market as a disciplinary mechanism for local representatives to foster economic development.(Zhang, 2006)

In addition, local governments were granted rights to hold and not to inform central government about extra-budget accounts. The fact that these accounts were not taxed by the central government,represented an additional incentive for local governments to develop the economy.(Zheng, 2005)

According to some authors, local governments in China are profit oriented and they behave like a big corporation. Whereas their representatives act like a entrepreneurs or managers, pursuing revenue opportunity. Oi (1992) has characterised this institutional framework in China as "local state corporatism."

Successful local economy represents secure revenue source and local official benefit from it in different ways. They can secure better infrastructure, public services etc. Additionally, they receive financial rewards and what is the most important by providing good economic growth they are likely to climb up the hierarchy within CCP. Because in China elections donot determine a political path of an individual, the most important influence isan economic performance of their jurisdictions. Thereby successful local officials could spread their experience at higher levels. Therefore, competition among officials from different jurisdiction is fierce. They are in constant pursuit of new ways to attract fresh capital to their regions. They are experimenting with new policies and learning from success and failure of other regions. (Zhang, 2011)

Interjurisdictional competition according to Pan et al. (2016) has created problems as well, such as the problem of local debt accumulation. In order to stay competitive and more attractive to new investment, local governments spend a substantial amount of money to provide better conditions, such as the first-class infrastructure to potential investors. This, so called debt-driven development, provides fast economic development, and increases employment rates in a short-run, but increase debt in the long-run. In addition, fiscal recentralisation combined with decentralisation of responsibilities for urban development, from central to local governments, increased the gap between expenditures and incomes. To overcome this rising problem, local governments engaged in excessive borrowing that represents significant risks to the fiscal stability of local communities and indirectly through transfer payment of debts by the central government to vertical fiscal imbalance.

It is evident that there is a risk that debt-driven economic development may jeopardisethe sustainable development, althoughitcannot be denied that it has brought spectacular results in the short-run. However, the issue cannot be a temporary anomaly, because there are reasonable grounds for believing that the causes lie in China's unique institutional landscape. (Pan, et al., 2016)

POLITICAL DECENTRALISATION AND CENTRAL-LOCAL RECIPROCITY

The next paradigm, introduced by political scientist Susan Shirk is political decentralisation (PD). She tried to identify institutional factors that influenced decentralisation in China's one-party political system and their impact on economic development. The main idea of Shirk´s theory is based on "reciprocal accountability", which describes a relation between top leaders, other members of CCP, and the Central Committee. Top leaders are chosen by Central Committee, which consists of elite party members also provincial leaders; while CCP leaders chose the members of Central Committee. At the same time, Central Committee chooses top CCP leaders. This relationship creates mutual accountability. Through their participation in Central Committee, provincial leaders play important role in decision-making, so the top leaders are establishing a base of support within this group by providing incentives to the provinces. At the same time, provincial leaders in order to climb the ladder are supporting the top leaders. However, Zheng (2005) dismisses her model, stating that many institutional elements have been excluded from the model, while the institutions were defined too narrow. It also lacks explanation why the top leaders as a rational actor don´t maximise their power in relation to the provinces and proceed with decentralisation. Reciprocal accountability also does not explain why the local officials expressed loyalty only to reformist leaders. (Zheng, 2005)

However, one is clear,a flexibility of China´s political system and propensity to innovation is based on decentralisation factors that are the crucial part of the China's one-party system.

POLITICAL CENTRALISATION AND STABLE GROWTH

The third paradigm, introduced by Yasheng Huang, emphasises the importance of political centralisation (PC) for the economic development. Economic success cannot be explained only by economic and political decentralisation because decentralisation often induces economic instability and macro-economic volatility at the state level. The success of the Chinese economy is hard to explain without introducingpolitical centralisation, which represents an institutional precondition for sustainable economic development. Neither of two theories, mentioned above,explain how negative consequences of decentralisationwere overcome. Interjurisdictionalcompetition could provide an explanation in the long-run. However, only political centralisation could guarantee successful federalism. The strong Chinese central government has enforced tight control of the transition of Chinese society and economy. In order to fight the local protectionism and to prevent the introduction of conservative measures by conservative local officials, central government introduced measures that either rewarded or punished local officials depending on their success to follow economic policies. Chinese central establishments have preserved a strong control over the removal, appointment, and promotion of provincial leaders, and that represents the fundamental constraint for local authorities. According to Huang PC and not ED determines the incentive structure for local officials and shapes their economicconduct. (Zheng, 2005)

Even though China has undergone a significant transition of economy and redistribution of power between centre and provinces, its political system, has stayed fundamentally unchanged. So, regardless how economically strong local officials have become, they are still political and bureaucratic subordinates.The process of decentralisation granted economic responsibilities for local authorities but it didn´t change the political system because central government retained crucial political responsibilities.

ECONOMIC CENTRALISATION

Susan Whiting (2000)pointed out thatlocal economies and their performance influence and induce institutional changes, not only other way around. Some changes, such as fiscal recentralisation, was a directly consequence of the decrease in revenues provided by local governments to the central government. Namely, local government used non-budgetary revenues, mainly from TVEs, as the main source of their income, therefore they lost the incentive to increase budgetary revenues. Therefore, the central government decided to establish the central fiscal institution and go with privatisation. The response of the local government was the change in willingness to support different types of property rights because they lost a big part of non-budgetary revenues.(Zheng, 2005)

Many changes on the local level were made in response to institutional changes on the national level. The 1997–1998 central banking reform, 1994 taxation reform and the privatisation are the most prominent one.

CONCLUSION

The analysis above provided us with the firm proof that the institutions do matter, especially in the economies that are undergoing the process of transition. China´s unique principle of transition from planned economy to market economy was a long road full of experiments and adjustments. As Zheng (1999) portrayed that the main characteristic of Chinese institutional system is the constant **adjustment** to the changes in society with a goal to sustain political stability and provide economic development. (Zheng, 1999) From the situation where the formal legal framework is incomplete, volatile, and unpredictable China achieved stability and established market-based institutions without jeopardising its political system and stability. Although some scholars mostly from the West have hypothesised that only drastic political changes leading to a Western style democracy, such as those undertaken by Gorbachev could lead to successful transition, China´s way proved to be more successful. Big bang approach undertaken by Eastern European countries brought a lot of social and economic problems. Nowadays, merits of the gradual approach to reforms and opening up of the China are increasingly appreciated.

China went through different phases, since the establishment of PRC. It started with the reforms designed in Moscow, based on the pre-war Soviet model with the heavy industry in focus. Continued with the "Great Leap Forward" that produced the biggest famine in recorded human history. Although, GLF produced a massive disturbance in a food supply, with the disastrous consequences it was from an organisational point of view,an important step for future development of China because it induced **decentralisation** that will become one of the main features of China´s reforms and the formula for success. With GLF, China abandonedthe Soviet model, replaced the central planning with regional competition and opened the door for the market economy. The competition among provincial governments will evolve in the motor of the reform. The central government also encouraged regions to experiment with the different policies to find unique ways to organise collective life and production. Already with the GLF the main aspects that characterise China´s institutional reform were observable decentralisation, regional competition and experimentation. Additionally, the foundation for Chinese manufacturing wonder was laid down. Rural industry, based on TVEs which were firmly embedded in local communities started to evolve. Although, the rural industry based on the tiny household business, that was highly adaptable, and market-oriented production units was thriving for centuries in rural China. Therefore, changes in rural industry played the important role in the transition from centrally planned to market economy. In general, the speed of transition in rural China determined the speed of reforms. As Huang (2012) has pointed out Chinese type of capitalism is essentially rural in its origin. When Deng introduced decentralisation through different responsibility systems connection between effort and reward was restored, and that increased the productivity. Decentralisation through responsibility systems,in reality,meant that day-to-day business at the farms or infactories isthe responsibility of peasants and managers, and not the Party. This delegation of decision-making was also a product of the experiments on the local level. A bottom-up approach to reforms, where the ideas were coming from the lower level authorities is also the speciality of the Chinese reforms.

As already mentioned these changes spiked the fast development of TVEs. TVEs were highly adaptable to market conditions; they have used advantages of the China´s economic reality abundance in work force and land, low wages, capital scarcity, and develop to the motor of China´s transition process. Because the local governments could retain the part of their profit and use them as the extra-budgetary revenues they were interested to support their development. Cooperation with local government turned TVEs into small resilient enterprises that were often connected into highlycompetitive industrial clusters, which specialise in the production of the single product. Clustering of a vast number of tiny highly specialised enterprises, countlesstownships and villages become what is globally known as a “world`s factory”. It can be concluded that the development of TVEs came gradually, bottom-up, thanks to the decentralisation and as a response to overcome institutional weaknesses and constraints. The success of TVEs also pushed SOEs to increase productivity to be able to compete with them and eventually led to the privatisation of SOEs.

The most successful reforms in China came through **experiments** such as SEZ, responsibility systems. The experiments were organised on the small scale, because in case that the experiment fails, the negative consequence would be contained. But if it was successful the measures could be introduced to the rest of the country if applicable. This way it could be experimented with the policies from the market economy, without fear of possible negative escalation. Experimentation helped Chinese economy to adapt in a step by-step manner and it sheltered it from the big-bang effect that Eastern European countries faced.

Another aspect of institutional reforms unique for China is **intergovernmental competition**. Motivated by the central government incentives and out of fear of punishment in a case of failure, local officials engaged in competition.Their goal was to provide better economic results because their rewards are directly and intentionally dependent on the revenues local economies generate. Another incentive for local officials´ competition was the possibility for them to climb the political ladder. Since the governments in China are not constrained by the elections, this was the way they could advance in the party hierarchy.

To conclude, important and gradual changes to China´s institutional framework are characterised by decentralisation of decision making, bottom-up approach, experiments or economic change by trial and error, intergovernmental competition, reforms that started without blue-print are the main feature of Chinese transition.

One question, however, arises can this formula be applied in another country?

Zhao (2015) argues that China´s scenario cannot be replicated due to three unique initial conditions that cannot be find anywhere else: country size with a large internal marketthat can foster competition, labour force availability and a peculiar institutional system where the government is able to quickly make difficult and complex decisions and put them into actionswithout the constraint from democratic institutions.

In line with the institutional theory, it can be concluded that China model doesn´t offer prescriptions and countries should base their development and transition on its own conditions, making their own path. Yes, they could learn from experience from another economy but should find the model that suits their own institutional framework.

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