
TRUST AND GOVERNANCE

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EDITORS

VOLUME I IN THE RUSSELL SAGE FOUNDATION SERIES ON TRUST

Russell Sage Foundation • New York

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Library of Congress Cataloging-in-Publication Data

Trust and governance / Valerie Braithwaite and Margaret Levi, eds.

p. cm.

Includes bibliographical references and index.

ISBN 0-87154-134-3

1. Political ethics. 2. Political sociology. 3. Democracy.

I. Braithwaite, V. A. (Valerie A.), 1951- . II. Levi, Margaret.

JA79.T78 1998

98-2935

306.2—dc21

CIP

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112 East 64th Street, New York, New York 10021

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To Patrick N. Troy

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Chapter 7

The Mobilization of Private Investment as a Problem of Trust in Local Governance Structures

SUSAN H. WHITING

THE CONCEPT of trust is elusive; it is difficult to operationalize or measure and even more difficult to explain. The issue of trust arises in situations involving risk—specifically, "situations in which the risk one takes depends on the performance of another actor" (Coleman 1990, 91). The type of trust addressed in this chapter is specific as opposed to diffuse or general; in Russell Hardin's (1993) terms, "Trust is a three-part relation: A trusts B to do X" (506). In the context of trust in government, citizens either do or do not trust government agents to do X, where X may encompass a smaller or larger range of government commitments or responsibilities. This issue is distinct from the problem of generalized trust in government. Moreover, the type of trust addressed here is cognitive as opposed to non-cognitive; cognitive trust involves employing available information to make intentionally rational assessments of risky situations. Thus, the term *trust* as used here is analogous to the terms *assurance* as employed by the sociologists Toshio Yamagishi and Midori Yamagishi (1994) and *credible commitment* as employed by the political scientist Barry Weingast (1995).¹

Trust in Government

Operationalizing Trust

Attempts to operationalize the concept of trust in government fall into three main categories: surveys that elicit verbal expressions of trust in government,² experiments that elicit reactions indicative of trust in government (albeit in laboratory settings), and analyses of concrete actions or behaviors as indicators of trust in government. This chapter adopts the third approach; it focuses on a particular empirical phenomenon as an indicator of trust in government. It then considers four competing explanations of the phenomenon and evaluates their contributions to our understanding of the concept of trust in government.

The particular empirical phenomenon of interest involves private investment in fixed assets in industry in the People's Republic of China since the initiation of economic reforms in 1978. In theoretical terms this phenomenon stands as a useful proxy measure of trust in government. As numerous analysts of property rights have emphasized, private investors must "trust" the government to recognize and uphold their claims to their assets. Because the government apparatus as a whole enjoys a monopoly over the legitimate use of coercion, it is difficult to constrain its behavior. As the economic historian Douglass North (1990) has suggested, "If the state has coercive force, then those who run the state will use that force in their own interest at the expense of the rest of the society" (59). Indeed, if a private investor is not confident that he can reap the gains of his investment at some future point, then that assessment reduces the projected value of the investment and undermines the incentive to invest.

For economic actors to undertake costly actions necessary for economic development, they must expect to garner the return of their efforts. The potential redistribution of these returns—whether through a substantial tax increase, a wholesale reversal of the reform process, or outright confiscation—reduces the expected private return to these actions (Weingast, 1993, 2).

Where positive expectations of reaping the returns from an investment are weak or absent, private investment tends to be on a smaller scale and for a shorter term than would otherwise be the case.

We have only to contrast the organization of production in a Third World economy with that in an advanced industrial economy to be impressed by the consequences of poorly defined and/or ineffective prop-

erty rights. Not only will the institutional framework result in high costs of transacting in the former, but insecure property rights will result in using technologies that employ little fixed capital and do not entail long-term agreements. Firms will typically be small, except for those operated or protected by the government (North 1990, 64–5).

As these general treatments of property rights suggest, trust in the government is an important factor in the decisions of private investors to undertake the risk of investing—particularly in relatively immobile assets.³

Between 1956, when the Communist party abolished private industry as part of the socialist transformation, and 1978, which marked the initiation of reform, virtually no private industry existed in China. Since 1978, private industry has grown dramatically, but most private industrial enterprises are small compared with their publicly owned counterparts. The following discussion draws on data from China's rural industrial sector, where most private investment in industry is located.⁴ By 1987, the first year for which comprehensive statistics are available at the national level, privately invested firms accounted for 86 percent of firms in the rural industrial sector, although they accounted for only 37 percent of employment and only 23 percent of output (see table 7.1).⁵ By 1993, they accounted for 88 percent of firms, 42 percent of employment, and 28 percent of output. National statistics, however, mask tremendous regional variation in the significance of private industry.

Therefore, the focus here is on local governance structures.⁶ The subsequent analysis draws on comparative case study research conducted in two counties in the wealthy southeastern coastal region of China during the early- to mid-1990s.⁷ The two counties in Wenzhou and Shanghai differed dramatically in the roles played by private investment in the two local economies. The Wenzhou site (Yueqing County, Wenzhou Municipality, Zhejiang Province) was predominantly private; as can be seen in table 7.2, well over 90 percent of industrial enterprises were built with private investment and were privately owned. They provided most of the employment opportunities in industry (80 to 90 percent) and accounted for fully three-quarters of the gross value of industrial output. Thus, private industry played a much greater role in the economy of Yueqing County, Wenzhou, than in the national economy as a whole. In the Shanghai site (Songjiang County, Shanghai Municipality)⁸, by contrast, privately invested firms accounted for less than 40 percent of industrial enterprises, less than 10 percent of employment in industry, and only 2 percent of the gross value of industrial output (see table 7.3). Thus, private industry played a much smaller role in the economy of Song-

Table 7.1 Comparison of Publicly and Privately Invested Industrial Firms in China, 1987 to 1993

	1987	1988	1989	1990	1991	1992	1993
Number of firms (million)							
Publicly invested	0.97	1.00	0.98	0.94	n/a	0.97	1.07
Privately invested	6.11	6.74	6.38	6.28		6.97	8.12
Total	7.08	7.74	7.36	7.22		7.94	9.18
Employment (million)							
Publicly invested	33.40	35.07	34.52	34.01		38.21	42.39
Privately invested	19.27	21.96	21.72	21.71		25.15	30.20
Total	52.67	57.03	56.24	55.72		63.36	72.60
Gross value of output (billion yuan)							
Publicly invested	261.05	322.67	461.36	524.06		985.28	1696.22
Privately invested	80.19	106.36	153.06	185.65		334.04	659.63
Total	341.24	429.02	614.42	709.70		1319.34	2355.86
Private share of total (%)							
Number of firms	86	87	87	87		88	88
Employment	37	39	39	39		40	42
Gross value of output	23	25	25	26		25	28

Sources: *Zhongguo xiangzhen qiye nianjian* (China's Township and Village Enterprise Yearbook) 1978 to 1987, 1989, 1990, 1991, 1993, 1994. Beijing: Agricultural Publishing House.

Note: The table includes all industrial firms at the township level and below.

Table 7.2 Comparison of Publicly and Privately Invested Industrial Firms, Yueqing County, Wenzhou, 1988 to 1994

	1988	1989	1990	1991	1992	1993	1994
Number of firms							
Publicly invested	217	181	164	144	125	91	77
Privately invested	2947	2959	2723	2770	2972	3636	4370
Total	3164	3140	2887	2914	3097	3727	4447
Employment							
Publicly invested	13294	10605	10360	9425	12907	7523	6976
Privately invested	64787	54248	50808	52088	60127	73185	n/a
Total	78081	64853	61168	61513	73034	80708	n/a
Gross value of output (million yuan)							
Publicly invested	188.07	175.23	174.87	250.62	358.41	548.07	524.92
Privately invested	487.77	575.22	524.99	712.18	1220.80	1970.15	n/a
Total	675.84	750.45	699.86	962.80	1579.21	2518.22	n/a
Private share of total (%)							
Number of firms	93	94	94	95	96	98	98
Total Employment	83	84	83	85	82	91	n/a
Gross value of output	72	77	75	74	77	78	n/a

Sources: *Yueqing tongji nianjian* (Yueqing Statistical Yearbook) 1990, 1991, 1993, 1994, 1995. Yueqing: Yueqing Statistical Bureau.

Notes: The table includes all industrial firms at the township level and below. Privately invested firms are in the form of gufen hezuos qiyue.

Table 7.3 Comparison of Publicly and Privately Invested Industrial Firms, Songjiang County, Shanghai, 1989 to 1994

	1989	1990	1991	1992	1993	1994
Number of firms						
Publicly invested	1341	1300	1317	1359	1475	1352
Privately invested	173	267	349	555	711	826
Total	1514	1567	1666	1914	2186	2178
Employment						
Publicly invested	123992	124489	126551	127308	124297	115960
Privately invested	2427	3541	4947	8330	11893	12074
Total	126419	128030	131498	135638	136190	128034
Gross value of output (million yuan)						
Publicly invested	2110.82	2491.04	3127.44	4264.40	7027.22	11199.46
Privately invested	6.35	12.38	21.57	29.84	68.44	211.68
Total	2117.17	2503.42	3149.01	4294.24	7095.66	11411.14
Private share of total (%)						
Number of firms	11	17	21	29	33	38
Total employment	2	3	4	6	9	9
Gross value of output	0	0	1	1	1	2

Sources: *Songjiang tongji nianjian* (Songjiang Statistical Yearbook) 1989, 1991, 1992, 1993, 1994, 1995.

Notes: The table includes all industrial firms at the township level and below. Privately invested firms are in the form of *siying qiye*.

jiang County, Shanghai, than in the national economy as a whole. One of the challenges in analyzing private investment as a problem of trust in government is to explain these sharp regional variations.

Explaining Trust

Four distinct sets of competing explanations seek to account for the phenomenon of private investment in China: (1) the lure of huge potential gains in the marketplace even in the absence of trust in government, (2) trust in government stemming from third-party enforcement by the courts, (3) trust in government stemming from dense interpersonal networks that extend into the government apparatus, and (4) trust in government reflecting the institutionally defined interests of local officials.⁹

The first explanation for private investment in China suggests that the sheer magnitude of potential gains in the booming Chinese economy attracts private investment even in the absence of trust in government.¹⁰ The notion of cognitive trust presented by the sociologist James Coleman (1990) holds that "individuals will rationally place trust if the ratio of the probability that the trustee will keep the trust to the probability that he will not is greater than the ratio of the potential loss to the potential gain, or if $p/(1-p)$ is greater than L/G " (p. 104). In other words, $p \times G$ must be greater than $(1-p) \times L$, where p is the probability that the trustee is trustworthy, L is the potential loss if the trustee is untrustworthy, and G is the potential gain if the trustee is trustworthy. Thus, when a small fixed investment (representing a small potential loss) can produce potentially huge gains, even a very low probability that government is trustworthy will motivate a rational investor to invest.

The second explanation focuses on the role of third-party enforcement by the courts in establishing trust in the government (Levi 1995; North 1990). China's Civil Procedure Law and Administrative Litigation Law include within their scope complaints against government organs regarding failure to protect property rights, unlawful denial or revocation of licenses, and infringement of lawful business autonomy, among other possible transgressions.¹¹ In theory, these laws offer protection to private investors against transgressions by government agents.

The third explanation centers on dense interpersonal networks that extend into the government apparatus. The sociologists Victor Nee and Sijin Su (1996) focused on "longstanding social ties based on frequent face-to-face interactions" (113) as an important basis for trust and cooperation between entrepreneurs and the government in the Chinese political economy. They emphasized that "transaction costs

are lower in institutional settings where trust and cooperation flow from informal norms and established social relationships" (113). Dense interpersonal networks provide information as well as opportunities to impose sanctions that are important to the establishment of trust. Here it is important to note that the personal identities of those who staff the government apparatus and their membership in personal networks are key elements of the explanation. In a similar vein, the sociologists Nan Lin and Chih-jou Chen (1994) emphasized thick relationships based on familial ties. Finally, the sociologist David Wank (1995, 1996) considered thick-relationship trust in terms of patron-client ties. For Wank, "Long-term relations, by increasing the degree of trust and concern for mutual benefit, reduce the likelihood of opportunistic behavior by official-patrons vis-à-vis entrepreneur-clients" (178). He emphasized personal ties with government agents as a key source of protection for private investors in the absence of strong legal guarantees. Thus, dense interpersonal networks that reach into the government apparatus play a central role in generating trust in government. As the sociologist Ambrose King (1991, 79) noted, "Network building is used (consciously or unconsciously) by Chinese adults as a cultural strategy in mobilizing social resources for goal attainment in various spheres of social life. To a significant degree the cultural dynamic of *guanxi* building is a source of vitality in Chinese society" (79). As this statement suggests, the network explanation of trust in government is related to accounts of Chinese culture that emphasize the importance of networks of relations (*guanxi*) as a widespread sociocultural phenomenon.

The fourth explanation highlights the role of local officials embedded in local government institutions in China, who have an institutionally defined interest in protecting private investment in order to promote economic growth (Oi 1992, 1995; Whiting 1995; C. Wong 1991, 1992). In this approach to trust in government, unlike the approach based on interpersonal networks, the personal identities of those who staff the government apparatus are not central to the establishment of trust. Rather, the focus here is on the sources of *incentives* for government agents to be trustworthy in particular situations as shaped by the structure of governmental institutions. This approach is based on the notion of trust as encapsulated interest (Hardin 1993, 1995; Levi this volume). In theoretical terms, an encapsulated-interest account of trust in government involves several elements. First, as has been noted, the trustworthiness of government agents is evaluated in regard to *specific* government commitments and responsibilities (A trusts B to do X)—not in regard to the universe of possible government actions. Thus, the question of trust concerns a particular issue or set of issues. The second element concerns the trustworthiness of government agents; their trustworthiness is based on whether they have

the incentive to fulfill citizen trust with respect to X. In other words, for government agents to be trustworthy, they must have an *interest* in doing X. This element of trust as encapsulated interest finds a direct parallel in the literature on credible commitment. For government commitments to be credible, they must be self-enforcing. Thus, it is necessary to "create a set of arrangements that alter incentives so that carrying out the original bargain—rather than behaving opportunistically *ex post*—is compatible with the incentives facing the actors after the fact" (Weingast 1993, 4). In the third element of the encapsulated interest approach to trust, citizens must be aware of the existence of incentives for government agents to be trustworthy in order for trust to operate. Hardin finds this element to be the most difficult to satisfy. Citizens may know enough to distrust government, but he finds it implausible in most cases that they will know enough to place their trust in government meaningfully. "Few people can have an articulate understanding of the structures of various agencies and the roles within them or of the government overall to be confident of the incentives that role-holders have to be trustworthy" (Hardin 1995, 23). Hardin does, however, allow that "those most attentive to government will also be those most likely to know enough about governmental actions and structures to know whether the government and its agents are trustworthy" (1995, 25). Finally, the assessment of the trustworthiness of government agents is informed by citizens' past experiences with government agents with respect to X.¹² In sum, the nature of government institutions and the institutionally defined interests of government officials, particularly at the local level, where citizens have rich knowledge of government, are key in this account.¹³

Without advocating either static or mono-causal explanations, this chapter seeks to establish the importance of the encapsulated-interest approach to trust in government, focusing on the key role played by local governance structures in the Chinese reform process. To foreshadow the conclusion, this type of explanation goes furthest in explaining the striking regional variation that has characterized private investment in China.

Encapsulated Interest in Local Governance Structures in China

The encapsulated-interest approach to trust in government focuses on the *interests of government agents* in being trustworthy with respect to the claims of potential private investors in industry. The discussion that follows will show that local officials across locales in China had varied interests with respect to the protection and promotion of private industry during the first decade and a half of reform.

Local government officials are key players in the highly decentral-

ized Chinese political economy; their actions fundamentally shape property rights within their jurisdictions. The interests guiding their actions are determined by the incentives and constraints contained in their institutional environment.¹⁴ The institutional environment during the reform era has provided all local officials with powerful incentives to promote economic—and particularly industrial—development. The initial choices of local officials about *how* to promote industrial development, however, were constrained by a number of factors, in particular by the nature of available resources and by the larger political-legal and market environments in which local communities were embedded. As a result, the interests of local officials in protecting and promoting private industry varied markedly depending on the nature of these constraints.

All local officials share an interest in promoting industrial development. This common interest derives from two characteristic features of their institutional environment: the appointment system for local officials and the fiscal system that finances their activities. Local officials in China are appointed by their superiors at the next higher level in the administrative hierarchy. Their superiors employ specific performance criteria (*kaohe zhibiao*) to determine each official's level of remuneration, tenure of office, and opportunities for advancement. The criteria are designed to make party and government leaders responsible for the performance of the local community in economic as well as in social and political terms. Interviews reveal that, in practice, industrial growth is the single most important element in assessing performance.¹⁵ Yet in addition to economic performance, the provision of public goods, such as education, public health, and public order, is also considered in evaluating the overall performance of local leaders. Provision of these public goods is also linked to the success of industry in numerous ways. For example, local officials regard providing local residents with employment opportunities in industry as the primary means of maintaining public order. Moreover, industry is the main source of revenue for financing virtually all local government functions.

The incentives of local leaders are thus shaped by the nature of the fiscal system, since it determines the financial resources they can use to pursue their goals. Fiscal reforms initiated in 1980 created a revenue imperative for local officials by making local governments essentially self-financing at the same time that they increased the responsibility of local governments for financing public goods.¹⁶ Township officials came to depend overwhelmingly on revenues generated in local industry to cover township expenditures, creating an industry-centered tax structure in which the burden of taxation fell most heavily on industrial enterprises. Data collected in Shanghai and

Wenzhou in 1992 demonstrate that close to 90 percent of total fiscal revenue at the township level derived from local enterprises—overwhelmingly from industry. Thus, the scale of financial resources at the disposal of local cadres was closely tied to the success of local industry. Given the incentives contained in both the appointment system and the fiscal system, local officials made the vigorous promotion of local industry one of their main objectives.

The types of property rights that local officials chose to support in promoting local industry at the beginning of the reform period differed markedly across regions, however. Choices were constrained by the resources available in the community.¹⁷ In areas with a legacy of weak public enterprise development, such as Wenzhou, local cadres had a poor revenue base and little revenue to invest in publicly owned enterprises. When faced with the imperative of self-financing in the early 1980s, they responded by moving aggressively to support private property rights in order to encourage investment and develop the tax base.¹⁸ By contrast, in areas with a legacy of strong public enterprise development, such as Shanghai, local cadres exercised direct control over capital and other resources that allowed them to invest further in public enterprise development. Local officials in Shanghai resisted the development of private enterprise and opted instead to protect and nurture public enterprises, greatly facilitating the rapid growth of these firms. The absence of secure private property rights stifled investment on the part of private entrepreneurs in Shanghai.

The broader political-legal environment also influenced the kinds of property rights that local officials were willing and able to support. Outright private ownership did not receive formal legal recognition from the central government until 1988, fully ten years after the initiation of reform. In that year, the National People's Congress revised the constitution to legitimate private ownership, and the State Council passed regulations governing private enterprise.¹⁹ Nevertheless, even after the constitutional amendment and the passage of national regulations—both designed to legitimate private ownership—private enterprises continued to come under political attack at the central level. In particular, the economic rectification campaign of late 1988 through 1991, which targeted private enterprise, called into question the ability of local officials to protect investors from challenges from the center. The Fourth Plenum of the Thirteenth Central Committee in June 1989 led to an attack on “private entrepreneurs who use illegal methods to seek huge profits and thereby create great social disparity and contribute to discontent among the public.” The Fifth Plenum of the Thirteenth Central Committee, held in November 1989, determined that unspecified aspects of private development were “not

beneficial" to socialism and would be limited.²⁰ Even more recently, the Fifth Plenum of the Fourteenth Central Committee, held in September 1995, reiterated the position that "keeping the public sector of the economy as the dominant one . . . is the basic principle we have upheld for a long time. Any practice that shakes or forsakes the dominant position of the public sector is a departure from the socialist orientation."²¹ As Margaret Levi (this volume, 88) has suggested, "antagonism of government actors toward those they are supposed to serve" is a major source of distrust in government. Policy statements like those cited above elicit distrust in the *central* government on the part of private investors. Such distrust has two implications. First, it reinforces the importance of trust in *local* government officials. Second, it generates a preference on the part of private investors for the protection offered by nominally public forms of investment.

Finally, choices about property rights are constrained by the market environment—by the nature of markets for capital, land, and other inputs into industry and by the nature of markets for industrial products. The extent to which goods are allocated by bureaucratic decisions rather than by prices limits the ability of private investors, who function for the most part outside of formal bureaucratic channels, to realize the full value of their investments.²² As Victor Nee (1996) has noted, "In the state socialist redistributive economy officials act as monopolists who specify and enforce the rules of exchange by administrative fiat and exclude private entrepreneurs from taking part in legitimate economic activities. . . . The more developed the market economy, the greater the breadth and diversity of opportunities that develop outside the boundaries of the redistributive economy" (910–11). The perpetuation of bureaucratic control over the allocation of resources and the slow pace of marketization for land and capital constrain the effective exercise of private property rights over productive assets and shape the particular forms of property rights adopted in industry. In sum, choices about property rights are constrained by control over available resources as well as by the broader political and economic environments in which firms function. As a result of these constraints, the interests of local government officials in protecting private investments in industry have varied across locales.

Trust as Encapsulated Interest in Yueqing County, Wenzhou

The preceding discussion established that local officials in Wenzhou, unlike local officials in Shanghai, had an interest in mobilizing private capital for productive investment in rural industry. The development

of public enterprise was relatively weak in Wenzhou during the Maoist era. This area, which is located directly across from Taiwan, received little central or provincial investment during the years of greatest tension between the mainland and Taiwan. Furthermore, it is surrounded by mountains and coastline and therefore was relatively isolated from the major industrial centers of the region. As of 1978, per capita industrial output in Yueqing County, Wenzhou, was approximately one hundred ten yuan, compared with approximately six hundred yuan in Songjiang County, Shanghai.

With relatively few resources under the direct control of county and township governments and with the presence of at least some capital resources in the hands of local residents, local officials in Wenzhou sought to mobilize alternative, private sources of investment by specifying private property rights. As one local official commented, "We must encourage investment on the part of individuals because the [government] doesn't have enough money itself" (Informant 167). Local officials in Wenzhou were, however, limited in their ability to specify and provide effective political support for private property rights within the existing political-legal framework. The relatively hostile political climate for private investment, described in the last section, tended to inhibit private investment. Nevertheless, as James Coleman (1990) has pointed out, "The trustee [here, the local government] may engage in actions explicitly designed to lead the potential trustor to place trust. . . . These actions . . . to be successful must be based on an understanding (intuitive or explicit) of the potential trustor's basis for deciding whether or not to place trust" (96). Local government officials in Wenzhou were keenly aware of the concerns of private investors. According to an official of the Wenzhou System Reform Commission, his office consulted directly with more than twenty actual and potential private investors in order to ascertain what would encourage them to invest more actively (Informant 171). He reported that they were most concerned about two issues: the determination of the "political nature" (*dingxing*) of the enterprise and the disposition of firm assets. Specifically, the entrepreneurs wanted their firms legitimately to be considered *socialist* in nature, and they wanted clear title to their firms' assets; the former was seen as essential to their political security as well as to their ability to participate in restricted factor and product markets. In response, local officials in Wenzhou sought to work within the existing political-legal framework to meet investors' demands.

The framework for private investment adopted in Wenzhou addressed the ongoing concerns of private investors about the political nature of their enterprises and official recognition of their claims to their assets. In the early 1980s, well before the promulgation of regula-

tions governing outright private enterprise, local officials in Wenzhou began to encourage private investors to invest in privately formed cooperatives (*gufen hezuo qiye*). Such cooperatives were a response to both the discrimination against and the limitations on private investment (Informant 247). By 1987, the Wenzhou government had passed the first version of formal, *local* regulations governing shareholding cooperatives.²³ These regulations made clear that individuals who invested capital or other assets in such a cooperative venture retained private ownership of those assets. Moreover, the firm would be considered a part of the socialist economy; this determination was based on an implicit appeal to the precedent found in mutual aid teams and agricultural producers' cooperatives from the 1950s. As a recognized part of the socialist economy, private shareholding cooperatives would be taxed at the same rate as comparable public enterprises and would be eligible for tax breaks according to the guidelines governing comparable public enterprises. The regulations on private shareholding cooperatives not only encouraged private investment by legitimating it within the existing political-legal framework; they also enabled private investors to realize the full value of their assets, since the cooperatives were afforded better access to land and bank capital, which had yet to be fully marketized. For example, in 1987 local officials in Yueqing County began building an industrial park to accommodate the needs of investors in private shareholding cooperatives for land and factory space. With respect to capital resources, table 7.4 provides data on *average* bank loans outstanding for private shareholding cooperatives in Yueqing County. These statistics show that privately invested firms had access to the state-run banking system as early as 1985, and the size of loans grew dramatically in most years between 1985 and 1994. While the size of the average loan was relatively small, some loans to private investors were as large as two hundred fifty thousand yuan. Finally, private shareholding cooperatives also enjoyed access to bureaucratically controlled production permits that allowed firms to enter restricted product markets.

Private shareholding cooperatives whose status was based on locally promulgated regulations must be distinguished from private firms that registered *falsely* as public enterprises in Wenzhou and elsewhere. Like cooperatives, fake public enterprises emerged in response to the discrimination against and limitations on private investment. In practice, individual investors would pay local government officials a fee in return for nominal status as a public enterprise. Unlike cooperatives, however, fake public enterprises offered no official recognition of the claims of investors to their assets. On the contrary, the assets officially belonged to the local government. As both Chinese and Western scholars have pointed out, a change in the disposition of lo-

Table 7.4 Growth of Privately Invested Industrial Firms, Yueqing County, Wenzhou

Level	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Average employment per firm	16	18	10	22	18	19	19	20	20	n/a
Average bank loans outstanding per firm	1177	4195	4980	8426	9605	8898	17628	30784	45547	45437
Total value of fixed assets (million yuan)	n/a	20.37	23.51	48.42	70.77	89.74	117.36	211.53	430.24	819.49
Average value of fixed assets per firm	n/a	9159	10398	16430	23917	32956	42368	71174	118328	187526
Increase over previous year (%)		11.5	-46.3	130.7	-16.6	1.8	0.8	7.6	-0.5	n/a
Average employment per firm										
Average bank loans outstanding per firm		256.4	18.7	69.2	14.0	-7.4	98.1	74.6	48.0	-0.2
Total value of fixed assets (million yuan)		n/a	15.4	106.0	46.2	26.8	30.8	80.2	103.4	90.5
Average value of fixed assets per firm		n/a	13.5	58.0	45.6	37.8	28.6	68.0	66.3	58.5

Sources: *Yueqing tongji nianjian* (Yueqing Statistical Yearbook) 1990, 1991, 1992, 1993, 1994, 1995. Yueqing Statistical Bureau.

Notes: The table includes all industrial firms at the township level and below. Privately invested firms are in the form of *gufen hezuo qiye*.

cal officials toward these firms "could suddenly demote the founders and investors to mere employees with no right to a return on the capital that they had invested" (Clarke 1995, 305). Such occurrences were not unheard of—even in Wenzhou (Informants 146, 147). Moreover, fake public enterprises were particularly vulnerable to campaigns emanating from higher levels. For example, following the conservative line established at the Fourth Plenum of the Thirteenth Central Committee in 1989, the State Council launched a series of investigations into tax evasion in the private economy, targeting all private firms but focusing in particular on those firms that continued to register falsely as public enterprises.²⁴ This campaign extended even to Wenzhou, where fake public enterprises were targeted for rectification while shareholding cooperatives retained their status as legitimate members of the socialist economy.²⁵ Fake public enterprises were often established through personal ties between private investors and government officials; by contrast, private shareholding cooperatives were an institutionalized form of protection for private investors. Status as a private shareholding cooperative was based on guidelines set forth by the local government and not solely on the relationships between particular investors and particular officials.

Table 7.4 illustrates the growth of private shareholding cooperatives in Yueqing County since 1985. According to a representative of the Yueqing System Reform Commission, prior to 1985 only a few hundred private shareholding cooperatives existed in the county (Informant 247). While the number of enterprises has grown slowly since 1985 and fell slightly in 1990, the average value of fixed assets has increased steadily at double-digit rates—even during the years of economic rectification from 1989 through 1991. Moreover, with the greater perceived trust in local government officials' commitment to private shareholding cooperatives, this form of cooperative has become the dominant form of enterprise in many jurisdictions within Wenzhou. Table 7.2 highlights the predominant share of firms, employment, and industrial output accounted for by private shareholding cooperatives in Yueqing County between 1988 and 1994. Table 7.5 provides ownership breakdowns for number of firms, level of employment, and tax receipts for all industrial enterprises in one township in Yueqing County in 1991; shareholding cooperatives account for the largest share in every category.

Local officials in Wenzhou had an institutionally defined interest in promoting private industrial development. They furthered that interest by promulgating regulations designed to allay the fears of private investors and to create a local institutional environment conducive to private investment. Moreover, private investors in Wenzhou were

Table 7.5 Industrial Enterprises by Ownership, Hualing Town, Yueqing County, Wenzhou, 1991

	Firms		Employment		Tax Receipts	
	(units)	(% of total)	(thousands)	(% of total)	(million yuan)	(% of total)
Total	275	100	7.84	100	20.76	100
Publicly invested	24	9	1.69	21	8.51	41
Privately invested	251	91	6.15	79	12.26	59

Source: Informant 144.

Notes: Publicly invested firms are in the form of township and village enterprises (xiangban and cunban qiye), while privately invested firms are in the form of siying qiye and gufen hezuo qiye.

aware of the interests and actions of local officials on their behalf; indeed, they were consulted.

Trust as Encapsulated Interest in Songjiang County, Shanghai

While privately invested industrial enterprises developed ahead of national regulations in Wenzhou, private enterprises in industry did not emerge in Shanghai until the passage of national regulations in 1988.²⁶ Local officials regarded the development of private industry as a competitive threat to the public enterprises in Shanghai's suburban industrial sector. Given the area's strong endowment in public assets as of the early 1980s, the dependence of the local government on public enterprise for fiscal revenue, and the close ties between public enterprises and the local government, local officials in Shanghai had an interest in resisting the development of private enterprises, and they did so by creating barriers to entry and growth.

The constraints on private enterprise were of several kinds. Private firms were not granted licenses in any industrial sector or product line in which a publicly owned factory was already operating. Those private enterprises that did receive licenses were taxed aggressively. Limitations on access to land and credit were also major constraints on private enterprise development. Private enterprise owners in Songyang Town, Songjiang County in the early 1990s had to operate out of their own homes or rent abandoned buildings or sheds from the village. Even when private entrepreneurs won approval to expand existing workshops, their investments were minimal because of the belief that

the government could repossess the land and buildings at any time, depriving the owners of their assets (Informants 89 and 94). Similarly, in principle neither the local state-run bank nor the state-sponsored credit cooperative granted loans to private enterprises; as a bank representative in Songjiang put it, "In general, we don't make loans to private enterprises" (Informant 111).²⁷ In practice, however, about half the private enterprises in the township had received small, short-term loans from the credit cooperative, none of them exceeding ten thousand yuan (Informants 96 and 99). According to a representative of the credit cooperative, total loans to private firms accounted for approximately 0.2 percent of the credit cooperative's loans outstanding in 1991 (Informant 99).²⁸ The institutionally defined interests of local officials in Songjiang contributed to their lack of support for private investors.

Nevertheless, the fact that private investors in Songjiang were not completely barred from the local economy or entirely shut out of the loan market demonstrates that institutionally defined interests are not completely determinate. Interpersonal networks operate even where the broader institutional environment is unsupportive of private investment. As the following section demonstrates, however, the impact of the institutional environment is significant nonetheless.

A Comparison of Yueqing and Songjiang

Tables 7.2 to 7.6 present contrasting pictures of private industrial development in Songjiang County, Shanghai, and Yueqing County, Wenzhou. In Wenzhou private investment in industry began earlier than in Shanghai. The average size of fixed asset investment was larger across the board, and the average size increased much faster in every year until 1994. In 1989, as private industry was just beginning to develop in Songjiang, the average output value of private industrial firms in Yueqing was more than five times that in Songjiang; as of 1994, the average value of industrial output was still twice that in Songjiang. The comparative strength of private industry in Wenzhou likely reflects the more supportive environment provided by trustworthy local officials who had an institutionally defined interest in promoting private industry. Private property rights (particularly in private shareholding cooperatives) were more secure, and investors enjoyed better access to land and capital. These factors underpinned the strength of private industry in Yueqing, Wenzhou. Private investment accounted for more than 90 percent of enterprises, 80 to 90 percent of employment, and three-quarters of industrial output in Yueqing. By contrast, private investors accounted for 10 to 40 percent of enterprises, less than 10 percent of employment, and only 2 percent of industrial output in Songjiang.

Table 7.6 Growth of Privately Invested Industrial Firms, Songjiang County, Shanghai, 1989 to 1994

	1989	1990	1991	1992	1993	1994
Level						
Average employment per firm	14	13	14	15	17	15
Average bank loans outstanding per firm	n/a	n/a	n/a	n/a	n/a	n/a
Total registered capital (million yuan)	4.14	6.41	8.97	19.20	28.87	91.93
Average registered capital per firm	23913	24007	25702	34595	40605	111295
Increase over previous year (%)						
Average employment per firm		-5.5	6.9	5.9	11.4	-12.6
Average bank loans outstanding per firm		n/a	n/a	n/a	n/a	n/a
Total registered capital		54.9	39.9	114.0	50.4	218.4
Average registered capital per firm		0.4	7.1	34.6	17.4	174.1

Sources: *Songjiang tongji nianjian* (Songjiang Statistical Yearbook) 1989, 1991, 1992, 1993, 1994, 1995. Songjiang: Songjiang Statistical Bureau.
Notes: The table includes all industrial firms at the township level and below. Privately invested firms are in the form of *siying qiye*.

Conclusion

Each of the competing hypotheses regarding trust in government that were introduced at the beginning of this chapter contributes to a comprehensive explanation of the growth of private investment in China, where private investment stands as a proxy measure for trust in government at the local level. The first explanation suggests that the sheer magnitude of potential gains in the booming Chinese economy will attract private investment even in the absence of trust in local government. Private investment grew in Songjiang despite the relative lack of support on the part of local officials. Indeed, the burst of private investment in Songjiang in 1994 may reflect the increasing potential gains stemming from the overall economic development of the greater Shanghai area in the mid-1990s. The lure of potential gains does not, however, explain the contrasting growth paths in Songjiang and Yueqing up to 1994. By this account, virtually every feature of the marketplace in Shanghai suggests that it should have led Wenzhou in private investment. Proximity to market demand and development of transportation networks in particular suggest that the Shanghai region should consistently attract more investment. Wenzhou, sur-

rounded by mountains and coastline, is relatively isolated, and there is no rail connection linking Wenzhou to the major industrial centers of the region. Yet in 1994 total private investment in fixed assets in industry was eight hundred twenty million yuan in Yueqing, compared with ninety-two million yuan in Songjiang. The greater (average and total) magnitude of investment in Yueqing County, Wenzhou, suggests that the lure of potential gains is not the whole story.

Second, while the political-legal environment for private enterprise is gradually improving, it is unlikely to provide an adequate basis for trust in government at present. The case studies of private enterprise development in Songjiang and Yueqing did not provide any evidence that courts were an important means of resolving disputes involving government agencies—despite the existence of the Administrative Litigation Law. Indeed, legal experts and others express skepticism about the willingness and ability of courts to enforce rulings against the interests of local government officials (Clarke 1995; Lyons 1994; Potter 1994a, 1994b). Local officials continue to exert influence over courts as over other government agencies within their jurisdiction. Thus, while third-party enforcement is an important theoretical possibility, there is little evidence that the court system has sufficient independence from the government and party apparatuses to perform this role in China. Moreover, the inability of the courts to enforce rulings against the interests of local officials highlights the significance of the institutionally defined interests of those officials.

Third, the importance of interpersonal networks that extend into the government apparatus in China is undeniable. For example, personal connections affected the ability of private investors to secure bank loans in Songjiang. Nevertheless, reliance on personal connections in Songjiang did not result in private sector development comparable to that in Yueqing. Moreover, there is no evidence to suggest that the density of personal networks linking private entrepreneurs to government officials varies systematically by region. Indeed, such networks seem to pervade every region and to pervade the public and the private sectors alike. An explanation based on widespread cultural practice is less useful in accounting for local variation, even though such practice may be an important factor in explaining business success in general.²⁹ Furthermore, enterprises require scores of approvals, forms, and licenses in order to function, and the cultivation of personal connections for each and every approval is costly.³⁰ The need to rely solely on personal connections to underpin the emergence and growth of private enterprise may hinder its development significantly. Finally, many analysts of Chinese business practices highlight that sociocultural factors alone cannot explain investment behavior; the political environment is a crucial variable (Hamilton and Biggart 1988; Hsiao 1991; Whyte 1995).

The pattern of regional variation in private investment suggests systematic differences across locales. This chapter has focused on the institutionally defined interests of local government officials. It has shown that local officials in Wenzhou, regardless of their personal identities and personal connections, had an institutionally defined interest in promoting private industry. By contrast, local officials in Shanghai had an interest in resisting the rapid development of private industry. These interests significantly shaped the development of private enterprise in the two communities. This analysis highlights the utility of the encapsulated interest approach to trust in government—at least at the local level. While this approach does not explain the presence or absence of generalized trust in government, it does provide an explanation for intentionally rational trust in government with respect to particular local commitments and responsibilities.

Fieldwork for this study was supported by grants from the Committee for Scholarly Communications with the People's Republic of China and from the Joint Committee on Chinese Studies of the American Council of Learned Societies and the Social Science Research Council with funds provided by the Chiang Ching-kuo Foundation. Additional support was provided by a Faculty Research Grant from the China Studies Program of the University of Washington. I benefited from comments and discussion at two seminars sponsored by the Russell Sage Foundation: the Russell Sage Workshop on Trust and Social Structure in Seattle, September 1995, and the Russell Sage Workshop on Trust, New York, April 1996.

Notes

1. One of the issues involved in the use of the term *trust* is the association of positive affect for the trustee associated with lay use of term. No such connotation is intended here.
2. See, for example, the four-question battery in the National Election Study survey that constitutes the index of trust in government.
3. Moreover, the role of the government is important in underpinning other kinds of contracts besides property rights in fixed assets. The government can facilitate trade by acting as a neutral third party that can and will enforce contracts between firms. If the government does not regard private firms as legitimate, however, it is less likely to play this role in enforcing contracts in which private firms are involved.
4. The rural industrial sector includes all industrial enterprises at the township level or below. The township is the lowest level in the government administrative hierarchy in China. The township is directly subordinate to county government, which in turn is typically subordinate to a hierarchy of municipal, provincial, and central government.

5. These national statistics on privately invested firms do not distinguish between household firms employing up to eight workers (known as *getihu*) and private enterprises employing more than eight employees. It is the latter category that is of particular interest here, since firms of this size bear significantly more risk.
6. In the context of the PRC, local governance structures refer to the government and party organizations that make up the local state apparatus. There is significant overlap between these two organizations. For simplicity, they will be referred to in the discussion as "local government."
7. As part of a larger research project, counties were selected for variation in the concentration of property-rights forms in rural industry. Interviews were conducted with enterprise owners and managers as well as with an array of officials representing various government bureaus and bank and credit cooperative offices at the county, township, and (where applicable) village levels. Approximately two hundred fifty interviews were conducted in 1991, 1992, and 1996; of these, forty-seven interviews were conducted in Yueqing County and fifty-seven interviews were conducted in Songjiang County. Adapted for the purpose of analyzing trust in the government (using private investment in fixed assets as a proxy measure), the case study data under examination suffer from the problem of selection on the dependent variable. Private investment in the case study sites spans a wide range of variation, however, varying from 0 to near 100 percent of industrial investment in the sites. Moreover, the key independent variable, the institutionally defined interests of local officials, varies as well. Nevertheless, the primary utility of this set of case study data is to establish the plausibility of the institutional approach to trust in the state (introduced later in the chapter), to be tested by subsequent research.
8. Shanghai Municipality enjoys the status of a province and is governed directly by the central government.
9. A fifth possible explanation has been put forth by the economists Martin Weitzman and Chenggang Xu (1994, 138). They seek to explain the success of non-state industry in China on the basis of the *assumption* of a high level of society-wide trust. Weitzman and Xu's assumption is that "East Asia is a high-lambda [that is, high trust] society relative to Europe," where lambda is defined as follows: "Let the outcome to a repeated non-cooperative prisoner's dilemma game be quantified by the parameter lambda, which is valued between 0 and 1. A high value of lambda near one means a non-cooperative solution that comes close to looking as if it were the outcome of cooperative collusion. . . . The parameter lambda stands for the ability of a group of people to resolve prisoner's dilemma type free-riding problems internally, without the imposition of explicit rules of behavior, other things, including the size of the group, being equal. With a value 1 of lambda, people in a group would be able to resolve completely free-riding problems internally" (138). The assumption of a high-trust society, however, begs the very question of interest in

- this chapter; therefore, this approach will not receive further consideration here.
10. I thank Victor Nee for suggesting this approach.
 11. See, for example, "Zhonghua renmin gongheguo xingzheng susong fa (Administrative Litigation Law of the PRC)," translated in *Chinese Law and Government* 24(3) (Fall 1991): 22-34, especially 23.
 12. Hardin (1993) refers to this as "common sense Bayesianism" (517).
 13. For another treatment of local industrial development in China that suggests that information problems are less severe in smaller, local jurisdictions, see (Walder 1995).
 14. This analysis is based on the underlying assumption that local government officials seek to maintain their official positions in order to exercise the power and perquisites of office.
 15. For example, according to representatives of the county office of management and administration in Songjiang County, Shanghai, 1995 bonuses for township leaders were determined by five key indicators: gross value of industrial output, industrial profits from collective enterprises, GDP, receipts of local taxes, and total new investment. For each indicator, both the level and the increase over the previous year were assessed. The highest-paid government executive and party secretary were from the town with the highest combined ranking, while the lowest-paid were from the town with the lowest combined ranking. Looking at the level of and increase in the gross value of industrial output alone produces a virtually identical ranking (Informant 214 and Songjiang County Statistical Bureau *Songjiang tongji nianjian* 1996 [*Songjiang Statistical Yearbook* 1996]).
 16. This situation has a parallel in "unfunded mandates" to state and local governments in the U.S. system. On the Chinese fiscal system, see Byrd and Gelb 1990; Oi 1992; Whiting 1995; and Wong 1992.
 17. Under the incentive structure just outlined, local officials would be expected to prefer to promote publicly owned (collective) enterprises, other things being equal. The township government received taxes and fees from all enterprises, but as the owner of township-run collectives it also received profit remittances from these firms. Furthermore, as owner, the local government faced lower information costs in extracting revenue from these firms.
 18. A vast secondary literature has emerged on the Wenzhou model; see, for example, Fei and Luo 1988; He 1987; Yuan 1987; and Zhang and Li 1990a, 1990b. In English, see A. Liu 1992; Y. Liu 1992; Nolan and Dong 1990; Parris 1993; and Young 1989.
 19. For the revised text of the constitution, see "Zhonghua renmin gongheguo xianfa xiuzhengan," in *Zhongguo nongye nianjian*, 1989 (*Agricultural Yearbook of China*, 1989) (Beijing: Nongye chubanshe, 1989), 538. For the regu-

- lations, see "Zhonghua renmin gonghequo siying qiye zanxing tiaoli," "Zhonghua renmin gonghequo siying qiye suodeshui zanxing tiaoli," and "Guowuyuan Guanyu zhengshou siying qiye touzizhe geren shouru tiaojie shui de guiding," *Jingji Ribao* (*Economic Daily*), June 29, 1988, 2.
20. See State Council document [1989] #60, August 30, 1989: "Guowuyuan Guanyu dali jiaqiang chengxiang geti gongshanghu he siying qiye shuishou zhengguan gongzuo de jue ding (State Council Decision Regarding Vigorously Strengthening Tax Collection Work in Urban and Rural Individual Industrial and Commercial Enterprises and Private Enterprises)," in *Guowuyuan gongbao* (*State Council Bulletin*) 16 (September 20, 1989), 626-29; and Central Party document [1989] 11, November 9, 1989, "Zhonggong zhongyang guanyu jinyibu zhili zhengdun he shenhua gaige de jue ding," in State System Reform Commission Office, *Shiyijie sanzong quanhu yilai jingji tizhi gaige zhongyao wenjian huibian* (Beijing: Gaige chubanshe, 1990), 598-99.
 21. Yang Chungui, "Make an Effort to Grasp the Dialectics of Socialist Modernization—Studying Comrade Jiang Zemin's 'Correctly Handle Several Major Relationships in the Socialist Modernization Drive,' *Renmin ribao* (*People's Daily*), November 6, 1995, translated in Foreign Broadcast Information Service Daily Report—China, December 15, 1995, 17.
 22. The economist Yoram Barzel (1989) has established that "the greater is others' inclination to affect income from someone's asset without bearing the full cost of their actions, the lower is the value of the asset" (5).
 23. See, Wenzhou Municipality People's Government, "Guanyu nongcun gufen hezou giyu rougan wenti de zanxing guiding (Provisional Regulations Regarding Several Questions on Shareholding Cooperatives)," Mimeo, November 7, 1987.
 24. "Guowuyuan Guanyu dali jiaqiang chengxiang geti gongshanghu he siying qiye shuishou zhengguan gongzuo de jue ding (State Council Decision Regarding Vigorously Strengthening Tax Collection Work in Urban and Rural Individual Industrial and Commercial Enterprises and Private Enterprises)," in *Guowuyuan gongbao* (*State Council Bulletin*) 16 (September 20, 1989), 626-29.
 25. "Zhejiangsheng gongshang xingzheng guanliju guanyu qingli 'jia jiti' he dui hezuo jingying qiye ruhe dengji guanli de tongzhi ([1989] 21)," in Yueqing County System Reform Committee, *Gufen hezuo jingji wenjian huibian* (A Collection of Documents on the Cooperative Stock Economy) 1991. no publisher: 52-54.
 26. Note that this discussion excludes individual household firms (getihu). This type of household firm is not considered a private enterprise in the Chinese regulatory context. The distinction between getihu and other private firms is based on the notion that owners of getihu are themselves directly involved in labor, while owners of larger private firms—firms that employ more than eight workers—are engaged in the exploitation of labor. The cutoff at eight employees is derived from Marx. For a dis-

cussion of the ideological justification for distinguishing between getihu and other privately invested firms, see Wu 1994.

27. As is reflected in table 7.6, officials statistics for Songjiang County do not report bank loans to private enterprises.
28. A comparison of tables 7.4 and 7.6 shows that not only were there more privately invested firms in Yueqing than in Songjiang, but privately invested firms in Yueqing embodied significantly more capital, on average.
29. The sociologists Gary Hamilton and Nicole Woolsey Biggart (1988) make a similar point in their treatment of cultural explanations of East Asian business organization.
30. The sociologist Siu-lun Wong (1991) makes this point as well. Some level of trust in the institutions of government is required to complement personal trust; without it, social investment in personal trust would be too costly for business.

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