

On the Co-existence of Guanxi and a Formal Legal System in the PR China – An Institutionalist Approach

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1. Introductory Remarks

China's decision to apply for membership in the WTO and her eventual accession to the said institution highlights the Chinese efforts not only to play an active part in the world economy but also her willingness to establish a new, highly refined supra-individual system of order. The integration of the Chinese economy into the global economic system requires an institutional framework that supports market transactions on a global scale. The development of a legal system that ensures the availability of enforceable property rights beyond the boundaries of personalistic networks and adheres to global standards and therefore constitutes a logical and indispensable element of China's internationalisation process.

Such a legal system, however, will stand as a direct competitor to the established guanxi networks, which have been a main guarantor of property rights in Chinese history and are still a very important element of the Chinese economic system. Guanxi networks and a legal system thus characterise two independent systems of order, which are initially not mutually exclusive. And although their coexistence seems quite possible

within certain limits, the questions remains as to whether this coexistence is desirable and can be permanent from overall economic and individual perspectives.¹

This study examines the chances of survival Chinese guanxi-networks will have in the presence of a formal legal system adhering and being adapted to global standards. Employing the analytical instruments provided by the new institutional economics the study will start with an analysis of the institutional foundations and functional characteristics of guanxi networks (Section 2), followed by a corresponding analysis of the history and function of the legal systems in China (Section 3). The complementary and substitutive relationship between the two order systems of the guanxi network and the legal system are examined in Section 4. A summary of results concludes the study.

2. The Institution of Guanxi Networks

The Chinese guanxi networks can be understood as institutions that arose centuries ago to secure trade relations in an environment that was only insufficiently covered by a formal legal system.² The environment economic actors were facing was characterized by either a complete lack of formal systems of order, or the legal system was coming along with certain elements of arbitrariness that compromised this institution's power to bring order into economic interaction.³

¹ Although it must be noted that China's first Criminal Code can be dated back to the 6th century b. C. the first civil code was drafted in the period of the Republic of China (1911-1941). (Compare Needham, J. (1978): *Wissenschaft und Zivilisation in China*, Frankfurt am Main, p. 347.) The Criminal Code, however, served a different purpose as in many western countries. Compare also chapter 3 in this paper.

² Carr, J. L., Landa, J. T. (1983): *The Economics of Symbols, Clan Names, and Religion*, in. *The Journal of Legal Studies*, Vol. 12, pp. 135-156, here at 135; and Posner, R. A. (1980): *A theory of primitive society, with special reference to law*, in *Journal of Law and Economics*, Vol. 23, pp. 1-53 p. 25, 35-36.

³ It has been pointed out that: "[t]he simplest economic view of the state as an institution that enforces contracts and property rights and provides public goods poses a dilemma: A state with sufficient coercive power to do these things also has the power to withhold protection or confiscate private wealth." Greif, A., Milgrom, P., Weingast, B., R. (1994): *Coordination, Commitment, and*

Fulfilling its function as microcosms of personalistic order in an environment characterized by intransparent formal rule setting and rule execution, the institution of guanxi networks has survived through the centuries and become an integral part of the Chinese social system. Especially in the reform period since 1979, the organisation of (increasingly decentralized) economic activities by means of guanxi networks has regained importance. The Chinese reform model of gradual transition which has been advancing the restructuring of institutional conditions in the form of a hardly foreseeable trial-and-error procedure rather than a system of economic policy that creates planning confidence⁴ has been a cause of great institutional uncertainty in economic interaction.⁵ The reform period has been characterised by the dissolution of established, central-administrative ordering mechanisms and a not always simultaneous creation of new, more strongly market-oriented elements.⁶ This has led to vacuums in the established system of order which often have been filled by economic actors spontaneously reverting to traditional, institutional arrangements and behaviour patterns and thus to a new heyday of a personally oriented, relational assurance of transactions in guanxi networks.^{7, 8}

Enforcement: The Case of the Merchant Guild, in *The Journal of Political Economy*, Vol. 102, Issue 4, pp. 745-776, here p. 745f.

⁴ Rawski, T. G. (1999): Reforming China's Economy: What have we learned? in *The China Journal*, Vol. 41, pp. 139-156, here at p.142.

⁵ Wank, D. L. (1999): Producing Property Rights: Strategies, Networks, and Efficiency in Urban China's Nonstate Firms, in: Oi, J. C., Walder, A. G. (eds.) *Property Rights and Economic Reform in China*, Stanford, 1999, pp. 248-272 here at p. 251f.

⁶ The first formal contract legislation, which did not take effect until 1 July 1982, four years after the reform process had begun, was still strongly bound to the old central administrative system and quickly came into contradiction to subsequent laws and decrees. Nevertheless, the law was not revised until 1993 and it was not until October 1999 that a comprehensive, uniform contract law went into effect. Even more problematic than this delayed reform legislation is the poor enforcement of existing law, which is the result of administrative interventions and an often insufficient training of the personnel that enforces the law (Tao, Z., Zhu, T. (2001): An agency theory of transaction without contract enforcement: The case of China, in *China Economic Review*, Vol. 12, pp. 1-14, here at p. 3, Wank (1999) p. 264, 266).

⁷ It would be wrong, however, to attribute the recent gain in importance of the guanxi networks solely to the planning uncertainty that has arisen in the wake of the Chinese transformation process. Already in the pre-reform era, the Maoist policy of strengthening the allocative decision-making power of the state coupled with the expansion of the discretionary power of local cadres assisted the formation of

In numerous areas guanxi networks are today a main ordering factor in Chinese society, and virtually every Chinese person is connected to at least one guanxi network. The resources used for this purpose are by no means insignificant. In a village investigated by Yan in the province of Heilongjiang, a household spends between 10% and 20% of its disposable income for the nurturing of its guanxi networks.⁹ The Hong Kong Independent Commission Against Corruption (ICAC) determined in 1993 that Hong Kong businessmen spent 3% to 5% of their investment in mainland China on gifts and maintenance of guanxi networks.¹⁰

But what exactly is guanxi and how does it work?

Within the Chinese language the term “guanxi” has multiple meanings and is used in various contexts. It could refer to (a) the existence of a relationship between people who share a common element, (b) actual connections with frequent contact between and within groups of people, and (c) a contact person with little direct interaction.¹¹ As vague and multifaceted the usage of the term “guanxi” is, as different is the interpretation and description of its functional principles in the literature, reaching from

personalised relational networks: guanxi networks. The guanxi networks that developed in this period were profitably used and expanded in the era of economic restructuring under Deng Xiaoping (Nee, V. (2000): *The Role of the State in Making a Market Economy*, in *Journal of Institutional and Theoretical Economics*, Vol. 156, pp. 64-98, here at p. 68; Chan, K.-M. (1999): *Corruption in China: A Principal Agent Perspective*, in Wong, K.-H., Chan, H. S. (eds.): *Handbook of comparative public administration in the Asia-Pacific Basin, Public administration and public policy*, Vol. 73, New York, 1999, pp. 299-324) p. 317; Yan, Y. (1996): *The culture of guanxi in a north China village*, in *The China Journal*, Vol. 35, pp. 1-25, here at p. 19).

⁸ Following this argument Xin and Pearce describe the re-emerge of guanxi as a transitional arrangement bridging the time-gap until the formal institutional system is well established – a hypothesis the authors of this contribution do not share. Xin, K. R., Pearce, J. L. (1996): *Guanxi: connections as substitutes for formal institutional support*, in *Academy of Management Review*, Vol. 39, pp. 1641-1658, here at p. 1642f, compare to this point also Guthrie, D. (1998): *The Declining Significance of Guanxi in China’s Economic Transition*, in *The China Quarterly*, Vol. 154, pp. 254-282, and Guthrie, D. (1999): *Dragon in a Three-Piece Suit: The Emergence of Capitalism in China*, Pinceton.

⁹ Yan (1996): pp. 11-12

¹⁰ Ming Pao, 21.08.1993, as quoted in Chan (1999): p. 308.

“friendship”¹², “particularistic ties”¹³, “reciprocal exchange”¹⁴ to “social capital”¹⁵. Commonly guanxi is defined as some kind of “special relationship between a person who needs something and a person who has the ability to give something”¹⁶ in a wider sense this means `relationships or social connections based on mutual interest and benefits`. ¹⁷ By accepting the gift or service,¹⁸ the involved person obligates himself to perform an undefined reciprocal service at an unspecified time in the future.¹⁹ Thus an implicit contract is concluded the fulfilment of which is linked to the particular network.²⁰ Lastly, the acceptance of these contracts establishes obligations that constitute a mutual dependency within the network.

All in all even these broad and general definitions falls short on a very important element: Of course, guanxi networks are based on personal relations, but they are marked by certain common elements such as its members coming from the same village or region, having served in the same military unit, sharing attributes like staying in the same party units, schools, associations, etc.²¹ However, membership in a guanxi network is not limited to such common experience but can also be arranged by a person

¹¹ Fan, Y. (2002a): Guanxi’s Consequences: Personal Gains at Social Cost, in *Journal of Business Ethics*, Vol. 38, pp. 371-380, here at 371f and Bian, Y. (1994): Guanxi and the Allocation of Urban Jobs in China, in *The Cina Quarterly*, Vol. 140, pp. 971-999.

¹² Pye, L. (1982): *Chinese Commercial Negotiating Style*, Cambridge.

¹³ Jacobs, J. B. (1979): A preliminary model of particularistic ties in Chinese political alliances: kan-chi and kuan-his in a rural Taiwanese township, in *The China Quarterly*, Vol. 79, pp. 286-295.

¹⁴ Hwang, K.-K. (1987): Face and Favour: The Chinese Power Game, in *American Journal of Sociology*, Vol. 4 pp. 944-974.

¹⁵ Butterfield, F. (1982): *China: Alive in Bitter Sea*, New York.

¹⁶ Osland, G. E. (1990): Doing Business in China: A Framework for Cross-cultural Understanding, in *Marketing Intelligence and Planing*, Vol. 8 pp. 4-14, here at p. 4-5.

¹⁷ Yang, M. M. (1994): *Gift, Favors, Banquets: The Art of Social Relationship in China*, New York, pp. 64f.

¹⁸ As Fan notes these gifts, services and favors “can be intangible as advice/information/counselling or tangible as gifts/jobs/houses or any other products or services.” Fan, Y. (2002b): Questioning guanxi: definition, classification, and implication, in *International Business Review*, Vol. 11, pp. 543-561, here at p.549.

¹⁹ Yang (1994): pp. 123-127.

²⁰ Hsing, Y.-T. (1998): *Making Capitalism in China: The Taiwan Connection*, New York, pp. 134ff.

²¹ This is what Lee, Pae, and Wong call “perceived similarity” as the founding basis of a guanxi relationship. Lee, D.-J., Pae, J. H., Wong, Y. H. (2001): A model of close business relationships in China (guanxi), in *European Journal of Marketing*, Vol. 35, pp. 51-69, here at p. 56.

in a position of trust whose reputation is the guarantee of the proper behaviour of the person introduced. In this way individual people are able to expand their radius of economic relations, backed up by guanxi networks, to include various networks each with different resources.²² As Fan puts it: "... through one single guanxi, one can get access to a much wider network of connections."²³

Seen in perspective, the ordering problem laying at the centre of the institution of guanxi networks, is that individuals are faced with the problem of conducting transactions in an unstable institutional and therefore high-risk environment which – at least to some degree – require transaction-specific investment without the chance of referring to an independent formal legal system.

In this context, the Chinese guanxi networks provide a practicable, and under the given conditions, a transaction-cost-minimizing (best practice) solution for the problem: The mutual exchange of services and the acceptance of abstract debt obligations is the main integrating force within a guanxi network. It can be understood as a mutual investment in social capital,²⁴ which is the framework of a system of order that co-ordinates the interaction between the network members.²⁵ The Guanxi networks themselves may be understood as clubs that guarantee their members the enforceability of available property rights in an institutionally disorderly environment and thus, lowering transaction costs.²⁶ The expenses necessary for club membership (gift giving, mutual

²² 'Resources' refer to the information, goods and services accessible to the affiliated club members. Krug, B., Polos, L. (2000): *Entrepreneurs, Enterprise, and Evolution: The Case of China*, paper presented at *The Annual Meeting of the International Society for New Institutional Economics*, Tübingen 2000, here at p. 14.

²³ Fan, 2002b, p 548.

²⁴ Compare Dasgupta, P, Serageldin, I. (1999): *Social Capital. A Multifaceted Perspective*, Washington.

²⁵ Butterfield, 1982, p. 90ff. and Bourdieu, P. (1986): *The forms of capital*, in: Richardson, J. G. (ed.): *Handbook of Theory and Research for the Sociology of Education*, New York, pp. 241-258, here at p. 248-249.

²⁶ Compare Lee, Pae, Wong (2001): p. 51 and Luo, Y. (1997): *Guanxi and Performance of Foreign-invested Enterprises in China: An Empirical Inquiry*, in *Management International Review*, Vol. 37, pp. 51-70, here at 53-55.

exchange of favors, etc.) can be seen as an investment in social capital which upon joining take the characteristic of sunk costs. Once a member, the club assures that member's disposal over her rights to a certain degree: As long as the individual performs economic transactions within the club – i.e. among and with other club members – contract fulfillment is assured in that information regarding the honoring or breaching of contracts spreads rapidly among the club members. Co-operative, contract-honoring behavior thus becomes the dominant strategy even in one-period games (unique transactions between club members) since these unique games are bound up in an iterative system of multiple games (transactions) with other club members.²⁷ As Davis puts it, guanxi network transactions are "...the equivalent of an infinitely repeated game with a set of people they know."²⁸ Honoring contracts and co-operative behavior is positively sanctioned by the possibility of engaging in further, low-cost transactions with club members. In contrast, the response to opportunistic behavior is a withdrawal of goodwill or even exclusion from the club,²⁹ which, for the club member affected not only means the loss of investment but also a massive cost increase for future transactions. These costs could be so high that withdrawal from the field of activity might become necessary with possibly existence-threatening implications.³⁰ Thus, "performance is implicitly enforced by the threat of termination of the transactional relationship and communication of the contractual failure ..."³¹ The

²⁷ Compare Axelrod, R. (1983): *The Evolution of Cooperation*, New York, who shows that co-operative behaviour only becomes the dominant strategy in repeated games and is able to overcome the prisoners' dilemma.

²⁸ Davis, H. (1995): *China Business: Context and Issues*, Hong Kong, p. 128ff.

²⁹ For a documentation of sanctions of varying degrees practised in China, see Wank, (1999): p. 265f.

³⁰ Carr, J. L., Landa, J. T. (1983): 138-139; for a concrete example of how the mechanism is used in a Chinese community, see Krug, Polos, (2000): p. 8.

³¹ Klein, Benjamin (1985): *Self-Enforcing Contracts*, in *Zeitschrift für die gesamte Staatswissenschaft/Journal of Institutional and Theoretical Economics*, Vol. 141, pp. 594-600, here p. 595.

increase in utility that can be gained by maintaining long-term business relations thus clearly exceeds the short-term gains from an opportunistic breach of contract.³²

The stock of social capital created in a guanxi network has the character of fixed costs for its members. These fixed cost elements, however, enable the variable costs of contacts, negotiations and implementation of transactions between club members to be reduced to a minimum.³³ Since the fixed costs are higher than the variable costs, the incentive for a high intensity of interaction is an integral part of the guanxi system.

On the basis of this co-ordinating mechanism which clearly reduces the transaction costs of economic exchanges, the Chinese guanxi networks have advanced the development of the division of labour in the economic process (and also economic development) in Chinese society over the centuries, and they continue to exist as complementary and parallel mechanisms for ordering economic interaction. The suitability of guanxi networks for the solution of the problem of transacting in an institutionally disorderly environment can eventually be seen in the ability of this institution to transform high-risk exchanges into self-implementing contracts.³⁴ At the same time, these networks are an approximation of an ideal solution in terms of institutional economics: with their significant investments in building the network, all

³² In addition it must be assumed, that reciprocity as a moral standard and socially embedded norm is influencing the honouring of this implicit contracts concluded with members of one's own network positively. As there are evidences that "reciprocity ... is a universal moral standard (Steidlmeier, 1999) in most, if not all cultures, and is of particular importance in an Asian context where social customs and traditions have traditionally worked as a support mechanism..." D'Souza, C. (2003): An Interference of Gift-Giving Within Asian Business Culture, in *Asia Pacific Journal of Marketing and Logistics*, Vol. 15, pp. 27-35, here at p. 32. Also Hwang, K.-K., 1987, p. 957ff., as well as Lin, Y.-M. (2002): Beyond Dyadic Social Exchange: Guanxi And Third-Party Effects, in Gold, T., Guthrie, D., Wank, D. (eds.): *Social Connections in China. Institutions, Culture, and the Changing Nature of Guanxi*, New York, 2002, pp. 57-77, here at 59f.

³³ Ben-Porath, Y. (1980): The F-Connection: Families, Friends, and Firms and the Organization of Exchange, in *Population and Development Review*, Vol. 6, pp. 1-30, here at p. 5-6.

³⁴ This mechanism is comparable to what Greif calls community responsibility system (CRS). Compare Greif, A. (2002): *Institutions and Impersonal Exchange: From Communal to Individual*

participating parties document a credible commitment; they expend resources which can only lead to a pay-off if future transactions are carried out in the interests of all contracting parties. The above argumentation shows that these contractual relations are ‘stable’ since all participating parties must have an interest in long-term transaction relationships. Because of their high portion of sunk investment, guanxi networks create governance structures that force contract-honouring behaviour on the transaction partners, analogous to vertical integration solutions.³⁵ Guanxi networks thus manage to provide an infrastructure in which the transaction partners can safeguard themselves from the ex post opportunism of any one side.

3. Codified Law and legal culture in China

The history of codified law in China dates back nearly 3000 years with its first criminal code being established in the 6th century b. C.³⁶ Since then the Chinese legal system has been developed against the background of a particular legal culture, which shapes the whole system of codified law in China until today. The legal culture not only shapes the attitude towards law and the legal system but also influences the kind of laws and regulations being codified. As Friedman states, legal culture

is the element of social attitude and value. ... Legal culture refers, then, to those parts of general culture – customs, opinions, ways of doing and thinking – that bend social forces towards or away from law and in particular ways. The term roughly describes attitude about law ...³⁷

Responsibility, in *Journal of Institutional and Theoretical Economics*, Vol. 158, pp. 168-213, here at pp. 169-172.

³⁵ Reja, B, Tavitie, A. (2000): *The Industrial Organization of Corruption: What is the Difference in Corruption Between Asia and Africa*, paper presented at *The Annual Conference of the International Society for New Institutional Economics*, Tübingen 2000, p. 5-8.

³⁶ Needham, 1978, p. 347.

³⁷ Friedman, L. M. (1975): *The Legal System*, New York, p. 15.

The legal culture in China was – for nearly 2000 years – shaped by two basic ideas, which are partly based on the Confucian philosophy. 1) there is the true Confucian principle of *li* which could be translated as common law (also: custom or norm) and is considered to be the main ordering mechanism within the society. 2) there is the legalist principle of *fa* representing the codified and formal system of law imposed by the prevailing ruling elite.³⁸ The relationship between *li* and *fa* – i. e. custom and law – could be described as a hierarchical one: *li* was primary while the codified law was secondary and, thus, dominated by customs and norms.³⁹ From this point of view it could be pointed out that in the history of traditional Chinese law and legal culture:

there was no civil law and commercial law because rules dealing with different social relations and behavior in daily life were provided by *li* after the Confucianization of law. Therefore, as a component of the traditional legal system, “law” is basically referred to as “penalty”, and the statutes of all the feudal dynasties can be regarded as “criminal law” or “penalty law.”⁴⁰

The first modernization of the Chinese legal system started in the late 19th century. Shen Jiaben, the commissioner in charge of the legal reform, advocated the establishing of modern law schools and organized the translation of several foreign laws. Lastly, the Qing Civil Code was drafted. In building on this first steps the legal reform was pushed forward during the period of the Republic of China. A new code of laws was drafted mainly in copying Western legal codes (for the most part the legal codes of the German BGB).⁴¹

³⁸ Heuser, R. (2003): Rechtskultur, in: Staiger, B., et al. (eds.): Das große China-Lexikon, pp. 606-609, here at p. 606.

³⁹ As a matter of fact the Chinese traditional system of laws does not know any kind of codified property rights as laws only deal with interhuman relationships all other concerns were handled by norms and common law. Compare Heuser, R., 2002, p. 607. Also compare Liang, H. (2003): Die Rezeption ausländischen Zivilrechts in China, in: Newsletter der Detusch-Chinesischen Juristenvereinigung, Vol. 10, pp.68-72.

⁴⁰ Wang, Y. (2002): Chinese Legal Reform, London, p. 21.

⁴¹ Wang, (2002) p. 9-10.

These first steps towards a rule of law were negated in the coming period of Socialist before any change in the legal culture could take place. With the establishment of the “People’s Republic of China” by the Communist Party in 1949 nearly all previously enacted laws were discarded. During the following ten years legal concepts and laws were imported from the Soviet Union with the purpose of establishing a socialist system. The legal system was mainly used to establish and maintain the power of the ruling elite.⁴² The already weak legal system was further destabilised by the following “Great Cultural Revolution”. Virtually all laws enacted and institutions build up so far were overthrown and no further laws were enacted for a period of more than 10 years. The whole legal infrastructure, i. e. law schools, research institutes, and courts were destroyed, attorneys, judges, lawyers and even courtroom personnel were convicted to “re-education”.

Lastly, with the beginning of the reform period in 1979 and after implementing the open-door policy the re-constitution of modern legal system was one of the main tasks. In the following years China has enacted more than 300 new laws and more than 700 regulations.⁴³ In addition the re-building of the legal infrastructure has been fostered, to make the new laws work.⁴⁴ In the course of the legal reform, the number of attorneys rose from 212 in 1979 up to 111.433 in 1999.⁴⁵ Although these figures show the rapid development of the legal system and its infrastructure in China, it also points at the

⁴² As Palmer states: “The law was to be regarded as inferior to political ideology. ... The emphasis in the law was not to be placed on the creation of rights for the individual but, rather, on punishment, correction, and the needs of those wielding power.” Palmer, M. (1992): What makes Socialist Law Socialist? – The Chinese Case, in: Feldbrugge, F. J. M. (ed.): *The Emancipation of Soviet Law*, Dordrecht, Boston, p. 53.

⁴³ For a history of commercial, company, and business law compare Kirby, W. C. (1995): *China unincorporated: company and business enterprise in twentieth-century China*, in: *The Journal of Asian Studies*, Vol. 54, No. 1, pp. 43-63.

⁴⁴ Wang, 2002, p. 1; also compare Fan, G., Xin, C. (1998): *The Role of Law and Legal Institutions in Asian Economic Development: The Case of China*, Development Discussion Paper No. 664, Harvard Institute for International Development, Harvard University, p. 17.

⁴⁵ Compare v. Senger, H. (2003): *Rechtspflege*, in: Staiger, B., et al. (eds.): *Das große China-Lexikon*, pp. 609-612, here at p. 611.

problems: the attorney-per-person rate is far smaller in developed countries. Considering the regional disparities it must be assumed that there are hardly any lawyers in the countryside at all. Additionally the lawyers were considered to be “state legal workers” and “loyal to socialism” and also were not free to work as individual legal advisor or be paid directly by their clients during the 80 and early 90.⁴⁶ Lastly the status of the whole judicial system was not authoritative in every day life.⁴⁷ Often judgement made by courts could not be executed because of interventions of other parts of (local) government.⁴⁸ Although the status of law has improved since the introduction of parts of Western legal system (and to some extent Western legal culture) and the still ongoing legal reform the confidence of people in the legal system is still weak. As Wang puts it, due to

...the fact that law was typically applied to people rather than applied by people, the Chinese people have come to regard law as a matter to be avoided...⁴⁹

All in all the Chinese legal system and its legal culture today is the sum of ideas of Confucian and Legalists theories, Soviet legal approaches and imported international laws and regulations. The legal infrastructure is still too underdeveloped – especially in the countryside – to promote a rule of law and allow a change in China’s legal culture. Despite the fact that in the last 20 years several programs were launched to popularize knowledge and awareness of law, most Chinese people simply do not understand or observe these laws. For a period of nearly 2000 years the Chinese legal culture was shaped by criminal law and regulations with punitive implications, thus, law in China is

⁴⁶ Wang (2002) p. 31.

⁴⁷ Compare Lin, J. (2002): Robe, Gavel, and Wigs too?, in: China Review, Issue 23, Autumn/Winter 2002, pp. 4-6.

⁴⁸ Fan, Xin (1998) p. 14f.

⁴⁹ Wang (2002) p. 22.

typically understood as criminal law.⁵⁰ Lastly, this means that the concept of rule of law is not established in China up to now.

4. Guanxi Networks and Codified Law as Competing Systems of Order

As shown above the Chinese guanxi networks are both efficient and transaction-cost-lowering co-ordination mechanisms for initiating, conducting and controlling transactions in an environment characterised by high institutional uncertainty. The question to be examined is the extent to which an intensified establishment of an institutionalised and codified legal system will lead to a displacement of the guanxi networks that permeate Chinese society, or whether the co-existence of two systems that offer legal security is possible in an economy in the long term.

The establishment of an institutional framework that offers legal security at a supra-individual level beyond social relationships seems at first glance to offer significant advantages especially with regard to transaction frequency, the free choice of transaction partners, and especially transaction costs.⁵¹ This should lead individuals no longer to rely on the system of guanxi networks to secure their transactions since there is now no uncertainty regarding the enforcement of contractual rights any more. From this standpoint, guanxi networks should gradually lose importance and ultimately disappear once a functioning legal system gradually becomes established.

⁵⁰ Fan, Xin (1998): p. 17f.

⁵¹ As a result of his cliometric studies, North asserts: 'The move, lengthy and uneven, from unwritten traditions and customs to written laws has been unidirectional as we have moved from less to more complex societies and is clearly related to increasing specialization and division of labor associated with more complex societies.' (North, D. C. (1990): *Institutions, Institutional Change and Economic Performance*, Cambridge, p. 46).

The superiority of a supra-individual legal system postulated here vis-à-vis the personalised guanxi networks is, at closer examination, doubtful and certainly not supportable as a categorical formulation. Supra-individual legal systems appear superior in terms of their ability to provide legal security, but this unambiguous assertion is no longer possible with respect to the transaction costs that are linked to the provision of the good “legal security”. Especially the utility and cost-based rationale for shifting transactions once co-ordinated by guanxi networks to the ordering mechanism of a legal system appear doubtful in terms of the concepts of path dependency and embeddedness.⁵²

Transaction Security as a Public or Club Good

In terms of the establishment of institutional order, legal security can be regarded as a public good. In contrast, legal security provided by guanxi networks, as discussed above, could be labelled a club good. Seen in these terms, a couple of characteristics emerge that must be considered in the analysis. The central feature here is the optimal club size. With an increasing number of club members, an effective sanctioning of infringements is no longer assured. Once the optimal size of a club has been exceeded, the costs of informing club members of individual infringements increase.⁵³ Sanctioning misbehaviour, which depends on the complete information of all club members regarding the trustworthiness of all others, can no longer be guaranteed under all circumstances. This could make opportunistic behaviour appear worthwhile for some individuals,⁵⁴ and the function of the club as a guarantor of legal security for its

⁵² For the future viability of guanxi networks, see also Wang, H. (2000): Informal Institutions and Foreign Direct Investment in China, in: *The Pacific Review*, Vol. 13, pp. 525-556.

⁵³ Carr, Landa (1983) pp.139-142.

⁵⁴ Buchanan, J. M. (1965): An Economic Theory of Clubs, in *Economica*, Vol. 32, pp. 1-14, here at 13-14.

members is thus challenged.⁵⁵ With a public good, provided by a codified and institutionalised legal system, this problem does not arise.⁵⁶ On the contrary, even an expansion of the number of ‘consumers’ of this good will not, by definition, allow any rivalry in consumption to arise. Additional users lower the per-capita payments without giving rise to crowding effects.⁵⁷ Especially in rapidly growing economies such as China, the increase in transaction partners and the advancing division of labour via specialisation is a motor for this growth.⁵⁸ With an increasing division of labour, Guanxi networks have definite limitations because of their club character, since the optimal club size is reached much before the optimal permeation of a division of labour (and accordingly the optimal number of transactions and transaction partners) has been reached. In this respect the formal legal system seems to be superior to the personalistic guanxi networks and possesses a potential to crowd out the latter.

Fixed and Variable Costs of Transaction Assurance

As shown above, guanxi networks can limit the variable costs of a transaction to a minimum. After a comparatively high initial investment in social capital for membership in the club, only marginal transaction costs (mostly limited to search costs) accrue for all further transactions. Since, however, the investments are in the form of sunk costs, these are no longer significant in an individual’s utility maximisation calculations. Guanxi networks thus contain an immanent incentive for maximising possible transactions, since each additional transaction must only be assessed in terms

⁵⁵ This can be seen in terms of the prisoners’ dilemma model in which defecting is the dominant strategy – as long as there is not an endless number of games. Once there is a significant likelihood that opportunistic behaviour will not be recognised and sanctioned because of information deficits, there is an incentive for opportunistic behaviour in dependency on the degree of sanctions – an incentive to prefer defecting over co-operating.

⁵⁶ Buchanan (1965) pp. 1-3.

⁵⁷ Sandler, T., Tschirhart, J. (1997): Club Theory: Thirty years later, in *Public Choice*, Vol. 93, pp. 335-355, here at pp. 336-338.

⁵⁸ North, D. C. (1984): Transaction Cost, Institutions, and Economic History, in *Journal of Institutional and Theoretical Economics*, Vol. 140, pp. 7-17, here at p. 11.

of its variable costs. In contrast, there are opportunity costs for club membership that arise because transactions with outsiders are only possible at greatly increased costs. These costs are hence a function of the club size, and decrease as the club size increases.⁵⁹

In an institutional legal system there are no fixed costs for the individual.⁶⁰ Legal security exists for every individual and protects every transaction. In such a system, however, there is a fundamental difference between the existence of rights and their enforcement.⁶¹ The legal security granted by such a system is thus closely bound to the credibility and impartial application of sanctions.⁶² If one of the supports is weakened, however, be it that the judiciary is not sufficiently independent or the executive is not able to enforce the imposed sanctions, the system loses its functionality in many areas.⁶³ It must be clearly understood that the judiciary must not only be free of preferences in a personal regard but must also give out clear signals of its credibility. A codified legal system does not establish the public good of contractual and legal security simply as a matter of course. Rather, it is the task of particularly specialised individuals to manifest this in everyday social dealings. It is not clear, however, whether precisely these

⁵⁹ See here also the discussion of optimal club size and the control costs dependent on this in Sandler/Tschirhart, 1997 and Carr/Landa, 1983.

⁶⁰ There are, however, overall fixed costs of a workable legal system. (Compare Schwartz, W. F., Tullock, G. (1975): *The Costs of a Legal System*, in *The Journal of Legal Studies*, Vol. 4, pp. 75-82, here at p. 77ff.) Although this cost must not directly be borne by the individual, they are at last covered by their taxes.

⁶¹ This is especially true in China, as Lin pointed out: "Many tasks remain to improve the effectiveness and the efficiency of China's legal system. Topping the list is the need for a system to safeguard the fundamental principle of 'independence of justice'. ... Although it is written in the constitutions and other laws, it must be prevented from being eroded in practices." Lin (2002): 5.

⁶² "The efficiency of the legal system is thus a function both of the definition of rights and the means employed to invoke governmental force to support of them." Schwartz, Tullock (1975) p. 75.

⁶³ Despite decades of intensive efforts in establishing a codified legal system with independent courts, great uncertainty still remains in China concerning the true independent status of the court system and thus the role of the courts as a legal arbiter (Wank (1999)).

specialists, who because of their institutional position have (spatially limited) monopoly power, can be exonerated of opportunistic behaviour.⁶⁴

If, in addition, an economic community is highly opportunistic, i. e. contractual infringements are relatively frequent, the cost of pursuing claims that the individual must bear are very high. In the case of a contractual infringement, the individual thus incurs extensive transaction costs, which can be characterised as legal implementation costs. Accordingly, an individual who engages in a transaction has a high ex ante uncertainty over the actual variable costs of the transaction, which are a function of the likelihood of a contract infringement by the transaction partner as well as the institutional law enforcement. This uncertainty becomes part of the individual's maximisation calculus and tends to reduce the number of transactions carried out.

Lastly, comparing the cost structures of guanxi and the legal system does not lead to a result as obvious as might be assumed. After all it is hardly even possible to predict an possible outcome of such a calculus: The costs of establishing and maintaining a legal system are eventually financed by taxes and fees, however, it is important to note that the ordinary tax-payer is not informed what share of his taxes and fees is employed to facilitate these tasks. In addition, this intransparent cost-factor any individual bears does not guarantee for individual legal security, as the mere existence of judges and laws does not implicate protection on a personal level. Each time an individual takes recourse to the legal system it will have to bear additional variable costs in form of service fees for lawyers and spending time at court.

⁶⁴ Brennan, G., Güth, W., Kliemt, H. (1997): Trust in the shadow of the courts if judges are no better, Discussion Paper, Economic Series, No. 93, Humboldt-Universität zu Berlin, p. 2ff.; and Elster, J.

Path Dependency in the Use of Systems of Order

A reduction of the importance of guanxi networks for the co-ordination of economic transactions and a strengthening or sole use of the legal system is prevented to a great extent by the phenomenon of path dependency.⁶⁵ In the final analysis, path dependency points to competition failure in the area of institution selection owing to the lack of possibilities for setting up several parallel institutions and making a direct comparison of performance.^{66, 67} Instead, decisions are made under conditions of great uncertainty for the establishment of a specific institution for which investments are made which, in the form of sunk costs, create incentives for the retention of the institutional solution that has been chosen even if, at a later point in time, another institution may be considered a better option.⁶⁸ A change in systems of order among the competing systems is thus not made solely on the basis of weighing up the accruing costs per transaction. An economic actor with a short-term orientation will persist in using a once-established system of order until the opportunity costs of maintaining the existing system surpass the costs of constructing a new system within the calculation period that is relevant for this economic subject.

As shown above, guanxi networks display a great amount of sunk costs, which account for the great inertia of this ordering mechanism. The low variable costs of using this mechanism and the high fixed costs make it extremely resistant to changing to a

(1989): Social Norms and Economic Theory, in *Journal of Economic Perspectives*, Vol. 3, pp. 99-117, here at pp. 100f.

⁶⁵ David, P. (1985): Clio and the economics of QWERTY, in *American Economic Review*, Vol. 75, pp. 332-337.

⁶⁶ Compare North (1990) pp.92-94.

⁶⁷ In the course of the Chinese transformation process, precisely this has occurred in a number of cases. By selecting regions whose differing institutional arrangements were tested within the context of pilot projects, it was possible to test the performance and suitability of competing institutions (World Bank (1992): China. Reform and the Role of the Plan in the 1990's, A World Bank Country Study, Washington, here at p. 37f.).

⁶⁸ Kali, Raja (1999): Endogenous Business Networks, in: *Journal of Law, Economics and Organization*, Vol. 15, pp. 615-636, here p. 633.

competing mechanism once the initial investment has been made in the social capital it is based on.⁶⁹ This means that the performance of the Chinese legal system must be regarded as considerably superior to the guanxi networks for the individual economic actor to view as rational the use of the legal system instead of the guanxi networks to safeguard transactions. Alternatively, massive pressure by political decision-makers must be exerted for legal systems to displace the guanxi networks.⁷⁰

Embeddedness of Order Mechanisms

An additional argument for the continuation of guanxi networks stems from their embeddedness in Chinese society as a whole.⁷¹ Within the overall system, the choice and arrangement of institutions does not follow economic efficiency criteria alone but is also influenced by cultural and social factors.⁷² As Uzzi notes,

embeddedness is a logic of exchange that shapes motives and expectations and promotes coordinated adaptation. This logic is unique in that actors do not selfishly pursue immediate gains, but concentrate on cultivating long-term cooperative relationships⁷³

On the basis of their development within China over the centuries, the guanxi networks are strongly anchored in Chinese society and have an important function not only on the economic level but also dominate interaction on a political and social level. Guanxi

⁶⁹ Hannan, M. T.; Freeman, J. (1984): Structural Inertia and Organizational Change, in: *American Sociological Review*, Vol. 49, pp. 149-164, here p. 157.

⁷⁰ Such a politically induced replacement process can be associated with massive compensation payments to the 'losers' of structural change, depending on the political constellation.

⁷¹ Granovetter, M. (1985): Economic Action and Social Structure: The Problem of Embeddedness, in *American Journal of Sociology*, Vol. 91, pp. 481-510.

⁷² DiMaggio, P. (1994): Culture and Economy, in Smelser, N., Swedberg, R. (eds.): *The Handbook of Economic Sociology*, Princeton, 1994, pp. 27-57, here at p. 38.

⁷³ Uzzi, B. (1996): The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect, in *American Sociological Review*, Vol. 61 pp. 674-698, here at p. 693.

networks themselves are an important part of the social fabric, integrally linked to other (moral and social) foundations of Chinese sociality.⁷⁴

For Hamilton, guanxi networks are the primary cultural feature of China and stand, moreover, in an antagonistic relationship to the Western system based on legal rights.

In the West, Christianity combined with preexisting institutions to produce clear jurisdictional lines of top-down personalized authority. In the economic sphere, this led to legal definitions of property and ownership. But Chinese institutions rest on relationships and not jurisdictions, on obedience to one's own roles and not on bureaucratic command structures. [...] [B]oth jurisdictional principles and the autonomous individual are historically absent in the Chinese worldview, and thus were not incorporated in Chinese institutions. Instead, Chinese society consists of networks of people whose actions are oriented by normative social relationships.⁷⁵

In this light, it seems doubtful that a rapid replacement of guanxi networks – motivated by economic efficiency considerations alone – by a comprehensive legal system is likely.⁷⁶ Therefore, viewing guanxi and a formal legal system as opposing poles of which one must vanish might not be the whole story: as both exist it is fairly likely, that the well established and socially well embedded one – guanxi – will shape the understanding of what is to be expected from a legal system.⁷⁷ Thus, guanxi has shaped and will shape what is called the legal culture of a society.⁷⁸ After all, the system of

⁷⁴ Compare Gold, T., Guthrie, D., Wank, D. (2002): An Introduction to the Study of Guanxi, in Gold, T., Guthrie, D., Wank, D. (eds.): *Social Connections in China. Institutions, Culture, and the Changing Nature of Guanxi*, New York, 2002, pp. 3-20, here at 4f, who point at such basic social models as ganqing (sentiment), renqing (human feelings), mianzi (face), and bao (reciprocity).

⁷⁵ Hamilton, G. G. (1994): *Civilizations and the organization of economics*, in: Smelser, Neil; Swedberg, Richard (Hg.) (1994): *The Handbook of Economic Sociology*, Princeton, pp. 183-205, here at p. 198f.

⁷⁶ DiMaggio, however, sees a counter trend on the global level, 'If anything, relational contracting seems to be on the rise, as more firms develop "network" alternatives to conventional markets and hierarchies' (DiMaggio (1994)).

⁷⁷ Potter, P. B. (2002): *Guanxi and the PR Legal System: From Contradiction to Complementarity*, in Gold, T., Guthrie, D., Wank, D. (eds.): *Social Connections in China. Institutions, Culture, and the Changing Nature of Guanxi*, New York, 2002, pp. 179-195, here at p. 180f.

⁷⁸ Compare Friedman who defined legal culture in terms of customs and opinions, and the way of thinking and doing about the law (Friedman (1975) p. 15). Of course this argument holds as well if the underlying legal system is based on relational networks, as in the case of guanxi.

codified law already in place is an imported system of laws due to the requirements posed by the WTO to China. As Potter is pointing out:

These imported forms of law may be seen to reflect changing economic and philosophical conditions of their places of origin, whereas legal conduct in China and the response of Chinese society to the imported legal regime are dictated by local culture. ... The influence of tradition on cultural response to law is a key element in the interaction of law and custom.⁷⁹

Lastly this means that importing a legal system that is totally different from what is already working in the Chinese society will pose serious problems to the enforcement of that new kind of legal system. As it is not the enforcement by the state but also the legal culture that helps enforcing that legal regime.

5. Co-existence of Guanxi and the Legal System

The intensified efforts to establish a legal system in China raise the question of whether this will displace the guanxi networks. An analysis of the factors that determine such processes of institutional change – institutional performance, cost structures, path dependency and embeddedness – shows, however, that a substantial displacement of the guanxi networks, even with a further strengthening of the Chinese legal system, is hardly to be expected in the short run.

First of all, comparing the fixed and variable costs of enforcing one's own rights in a formal legal system and a personalistic system of order no obvious overall cost advantages or disadvantages become discernable. On the one hand, there are high specific investments necessary in order to become a member of a guanxi network. These sunk costs, however, are counterbalanced by the existence of hardly any variable cost of

safeguarding the single transaction. On the other hand, a formal legal system does not require any specific investments but is financed by taxes and fees. But in addition to these payments there are high variable costs of getting what is one's right once a contract has been broken, i. e. hiring lawyers, spending time at court, again paying fees etc. In the end, no clear judgement on the relative efficiency of the two systems can be made and no distinct crowding out effects are to be expected. Secondly, as guanxi networks shape the everyday life of virtually every Chinese it can be regarded as an important part of the overall social fabric. Thus, it is deeply embedded in the social and cultural background of the Chinese society and therefore shapes the attitude towards law and the legal culture itself. As long as the legal culture remains unchanged, guanxi networks it will continue to be one of the main barriers to the implementation of imported laws and legal concepts and will pose serious problems to the enforcement of any new kind of legal system. Lastly, however, it must be considered that guanxi networks have strict limitations: The main ordering mechanism (i. e. sanctioning misbehaviour through expulsion) within the guanxi networks is strictly bound to the overall club size. It seems possible that in a rapidly growing economy the maximum club size poses a limit to the number of transactions carried out under the protective wing of the network. However, until now no crowding effects of guanxi networks could be observed.

All in all, it has become obvious that the import of a legal system is not possible without taking into consideration the underlying social system. As a matter of fact, the Chinese legal culture is shaped by the phenomenon of a personally bound system of order where socio-economic interaction takes place within close networks or clubs, that ensure the enforceability of property rights: the guanxi networks. Summarizing the argumentation

⁷⁹ Potter (2002): p. 181-182.

guanxi networks will prevail and for a considerable period of time continue to co-exist with the newly established legal system.

The theoretical argument put forward in this discussion has to and will be tested in the field. Empirical research scheduled for spring 2003, however, had to be postponed due to the SARS epidemic. The fieldwork has now been rescheduled for autumn 2003.

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