Chapter 3: Theory

"Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct), and their enforcement characteristics". (North 1993)

Political science of the early kind was pretty much equivalent to institutionalism, albeit the definition of institutions above is a broadened one resulting from later debate and developments in social science. Constitutions, legal systems and governmental structures were the targets of research early political research. One well-known example relevant to this study is Max Weber's "The Protestant Ethic and the Spirit of Capitalism" which linked institutions such as protestant work ethic, independent and professional bureaucracy and capitalism. After World War II, other strains of political science came to the fore and put institutionalism "out of fashion". Behavioralism, Rational choice and Marxism all challenged institutionalism from different viewpoints and attracted significant following. In the words of Vivien Lowndes, "The clear message was that there was much, much more to politics than the formal arrangements for representation, decision-making and policy implementation"(in Marsh-Stoker 2002:90). In the 1980s, Institutions and their importance made a comeback in the political debate, much due to influential work such as that of March-Olsen (1989) and North (1981 and 1990). The core issue of contention in the new institutionalism debate became whether institutions were political actors in their own right (autonomous from the rest of society), or simply rational results of sums of individual interests (pawns and tools in the pursuits of distributive coalitions and self-interested individuals).

March and Olsen, based on a more narrow definition of institutions as political-administrative rules and organizations, argue that institutions are autonomous from social forces and define the identities of individuals, groups and entire societies – or as March-Olsen (1989:17) suggested "define and defend values, norms, interests, identities, and beliefs".

Quite opposed to this ‘normative’ institutionalism is rational choice institutionalism which stresses preferences as endogenously determined and relatively stable over time (i.e. utility maximization). Lowndes argues (in Marsh-Stoker 2002:95) that this approach posits the role of institutions as determining what strategies are suitable in a particular institutional environment for pursuing these stable preferences.

Despite these disagreements, “new institutionalisms” in general have changed the focus of study from institutions as stable, formal, independent, value-neutral organizations towards institutions as more informal, dynamic, value-dependent and embedded in society. Important to our purpose here is the introduction of the path-dependence concept of institutional change – that important policy choices (such as opening China to foreign direct investment) delimits the available choices of institutional rules and practices in managing this change in the future. Lowndes (in Marsh-Stoker 2002:97,99 and 101) and March-Olsen (1989:34) imply that institutions change as for example local communist cadres come into contact with novelties and, if these novelties are prevalent in their everyday environment (Field research for this study indicates there have been many such novelties) cadres encode these into new routines and rules. Kunshan’s previous policy decisions of relying on fully foreign-owned firms and selling land use rights to them thus make future policy choices dependent on those choices – path dependent, as the argument goes.

In sum, the changes to and developments of new institutionalism in social science through this long-term debate are well represented by the broad definition of the term “institution” at the top of this section.

Limits of the concept of “institution”

With North’s definition of institutions, there is a risk that so many formal or informal rules are included in the concept that it ultimately confuses more than it explains. In this thesis, I adapt the limitation suggested by Lowndes (in Marsh-Stoker 2002:103) and Peters (1999:74), that what is to be studied is the specific rules, compliance procedures and standard operating procedures that structure relations between actors in the state and the economy and between these two spheres Lowndes writes: *"The researcher's aim should be to identify the specific rules of behavior that are agreed upon and (in general) followed by agents, whether explicitly or tacitly agreed. Informal institutional rules are, in this formulation, distinct from personal habits or 'rules of thumb': they are specific to a particular political or governmental setting, they are recognized by actors (if not always adhered to), and can be described and explained to the researcher"* (2002:103). In other words, it is the rules and procedures that define relations between, in my case, the local government of Kunshan and foreign investors that is in focus here (these institutions are often referred to by the Kunshan government as "the Kunshan way" – a basic attitude of fast and predictable service) . The case study in this thesis will not deal with law texts, but mainly with manifestations of operations of administrative organs – their rules of behavior.

Institutions and motives

Another question we need to pose is in what direction the casual arrow points: are institutions tools of people that design and develop them by conscious design and action or rather something that evolve out of the environment by accident? There is no unified and uncontroversial answer to be found in the literature. March-Olsen (1989:159) from the normative institutionalism camp argue that 'institutional actors are driven by institutional duties', meaning that institutions are structures that play a part in designing actors' motives. Normative institutionalism recognizes that the environments in which an institution exists changes, such as changes in relative prices of capital, labor, land and knowledge which are overarching themes of any story of economic development and industrialization. Lowndes (in Marsh-Stoker 2002:105) suggests that with changing environments, institutional actors are presumed to adopt rules to 'make sense of changing environments'. Normative institutionalism thus leaves space for individuals acting to change institutions, probably initiated by a change in environment. Institutions thus evolve, but at the same time are durable due to the norm-setting capacity they build up over time. The idea that institutions evolve without a particular endpoint in mind, and that they do so in a decentralized fashion is an idea that resembles the main arguments of a classical liberal such as Hayek (1945).

The Rational Choice variant would instead argue that institutions are created and persist because of one reason – they solve collective action problems. Another way of saying this is that they decrease transaction costs, that they create a measure of stability and predictability as to actors' likely behavior. As such, Rational Choice institutionalism according to Lowndes (in Marsh-Stoker 2002:105) does not attribute the durability of institutions even under changing environments to a norm-building function but rather that the costs of switching institutional rules, such as learning to operate under the new rules and "playing the new game" only leads to institutional change when the benefit outweigh the adaption costs. An example of such a situation would be the decision of the Chinese Communist Party to allow experiments with capitalism in Shenzhen, Guangdong in the 1980s – a new game altogether that indeed produced considerable friction inside the party and would take time to learn to play but nonetheless with ample evidence that it could be a worthwhile change.

Douglass North (1990:83) tries to integrate these two views in that he attributes the stability of institutions to 'a comfortable feeling of knowing what we are doing and where we are going' – i.e. they minimize uncertainty for us risk-averse humans, whether this is efficient as in compatible with growing societal wealth or not. At the same time North (1990:83) claims that 'the agent of change is the individual entrepreneur responding to the incentives embodied in the institutional framework, and that the sources of change are changing relative prices or preferences'. The key, as we will see below, are that institutions tend to change fast and thus become more unstable in a society where relative prices of production factors changes fast. These are important because they change our incentives in human interaction. They include factors such as ratio of labor-capital-land, the cost of information and communication, changes in taste and changes in technology, where North (1990:84) especially points out the importance of military technology. Some of these variables are exogenous, caused by outside factors, such as the Black Death which lowered the ratio of labor to land and therefore led to important changes and finally abolition of feudalism, as discussed at length by North (1981). Another is the oil crisis in the 1970s which created incentives to find alternative sources of energy and develop gas-economizing cars. Other changes are endogenous, internal due to maximizing effects of agents. One such example is how a voucher system for public funding and private choice of primary and secondary education in Sweden have created some dynamism in the provision of education and has altered the bargaining power between traditional public monopolies and parents and children.

Institutions and economic growth

This section serves as a link between the theory of institutions on one hand and our case study of wealth creation in contemporary Kunshan on the other by examining what institutions have proven effective at creating wealth in economic history and how this is relevant to government strategies and organizations in facilitating growth in the 21st century. A broad story of institutions in economic history is necessary to understand the forces at work in Kunshan and the lower Chang Jiang River today.

'The existence of a state is essential for economic growth; the state, however, is the source of man-made economic decline' (North 1981:20). This deeply ambiguous relationship between wealth creation and the state is raised by Douglass North in his attempt to reintroduce institutions in economic history. A key part of this is his narrative of economic history and the institution of the state for the entirety of its history since humans settled permanently to work the land. As humans settled permanently, the organization known as the state arose. There are two basic theories as to how this happened; the Hobbesian argument for a social contract in avoidance of anarchy on the one hand, and a predatory and exploiting state on the other, where the purpose of the state is akin to that of a bandit. North defines the state as 'an organization with a comparative advantage in violence, extending over geographic area whose boundaries are determined by its power to tax its constituents". If the method is threat of violence or violence, the end is creating and upholding a central institution in human society – property rights. According to North (1981:21-22), *'The essence of property rights is the right to exclude, and an organization which has a comparative advantage in violence is in the position to specify and enforce property rights'.*

Property rights regimes leading to sustained economic growth (meaning growth of production outpaces growth in population) are rare in economic history. Most states and civilizations have been under property rights regimes that has not created sufficient wealth and therefore faced decline and in most cases oblivion. Known pre-19th century examples of property rights sufficient for longer periods of sustained growth include The Tang, The Song, The Netherlands, The United Kingdom and the Roman Republic and Empire. In these cases, a key factor singled out is their ability to realize economies of scale in the provision of justice, law and defense – the basic tasks of any state. Even if the "order" provided was generally despotic and bandit-like, such states did reduce the transaction costs and uncertainties sufficiently to allow for some capital accumulation to take place over the long term (North 1981:24).

No matter whether a property rights configuration leads to economic growth or stagnation, it is by nature unstable as in dynamic, prone to alter with altering relative prices of things such as labor, capital, land, information, communication etc. Changes in relative prices all affect the bargaining strengths of certain groups vis-à-vis the ruler and other groups. In a growing economy this is intuitive – just consider, for example, how free trade, movements of capital and rapidly decreasing costs of communication are rapidly undermining the bargaining power of traditional labor unions and the economic power of national governments in first world countries. This has also led to real changes in property rights configurations as seen for example in the pressure downwards on the corporate profit tax rates in the developed world. In the case of stagnant and non-growing economies where inefficient property rights persist, the state comes under threat from other states that have increased their productivity and thus capacity for violence.

North (1981:4-28) explains the inability of any state in history to sustain economic growth to 5 major contradictions. First, Rulers have struggled with the conflict of extracting the maximum amount of rent for themselves (or the group they serve) in the short term, which is in conflict of increasing the revenue long-term since it may hamper incentives for productivity growth and increase transaction costs.

Second, the bureaucracy created by the ruler for the purpose of extracting taxes and providing public goods in exchange, may “leak” less or more resources to the self-interested actions of agents, since there are costs and practical limits to how closely these agents can be monitored and assuming they have interests not wholly identical to those of the ruler.

Third, the cost-effective size of states due, most importantly, to changing military technology is assumed to have changed. One example is more effective siege weapons using gunpowder tilted the advantage in modern European warfare in benefit of the offender, in effect forcing princes with survival ambitions to keep standing armies and eliminating most sovereign entities in favor of larger nation-states.

Fourth, effective property rights may challenge the vested interests of groups the ruler depends on for political support. Monopoly rights of these groups do not lead to growth but ensure they do not try to depose the ruler in favor of a competitor.

Fifth, efficient property rights in a growing society can actually make it harder to meter, monitor and collect taxes for the ruler as opposed to granting monopolies to a few actors which then have few options but pay the taxes the ruler requests

These factors thus eventually led to the decline of all great empires and civilizations. Because of the military competition between states, inefficient property rates eventually proved fatal. Consider the different reactions of China and Japan to a sudden realization that they had to increase the productivity and technology level in their economies or forfeit their independence as western colonies. In Japan under the Emperor Meiji a new set of property rights were established, amounting to avoiding foreign colonization even at the cost of internal conflict through the challenge of the monopoly rights of the landowning class. In China, Emperors such as Guangxu (光緒) tried to reform and modernize the state in a similar manner, but failed to challenge the landowning class and establishing a new set of property rights to benefit productivity increase. After violent and bloody revolutions, only after 1978 did China move decisively to establish an ownership structure that resembles the conditions that North (1981:29) calls a ‘set of property rights that [makes] the private rate of return on innovation, investment in human capital, and so forth approach the social rate'.

In other words, North describes a property rights collection as "efficient" if the beneficial effects for society of investments and education also has some direct individual benefit – saving and investing leading to greater wealth in the future, entrepreneurial activity and innovations leading to private wealth, respect, social position, family security, personal growth or whatever might be an individual reason for engaging in productive activity. The opposite of this being a situation where investment, education and commerce is subject to unpredictable personal gains – the situation in virtually all countries that have not experienced sustainable growth in the modern age. Our most important lesson from North's story however, is that assuming rulers wish to remain in office, they often face incentives in favor of inefficient property rights. These incentives exist for a variety of reasons, some outlined above.

Institutions and Ideology

So far, North's story conforms to the neoclassical norm of individual cost-and-benefit calculations that informs also the rational choice type of institutionalism. This is where North (1981:57) raises the objection that while neoclassical economics is the best tool we have to describe the performance of an economy at any one point in time, 'it does not and cannot explain the dynamics of change'. This is where the term 'ideology' is brought in to explain why individuals often act in ways defiant of their immediate self-interest. Protest movements at small immediate benefit but great risk to participants, hard-working individuals in an organization where the high cost of monitoring labor output should lead to shirking, voting behavior in parliaments that defy interest-groups, people donating blood and the relatively low level of littering on Taipei streets despite the lack of public trash-cans are all examples of behavior defiant of utility maximizing. The place of ideology in our reasoning about politico-economic institutions is also important. Ideas are part of individual decision-making and thus values and norms are able to strengthen – or undermine - behavior induced by institutions. In the history of political science there has been much debate on this topic, a notable example being Maximillian Weber's (1930) attempt to establish the existence of a symbiotic relationship between Calvinism and capitalist institutions. Classical liberals like Ludwig von Mises (1949:178) acknowledged the role of ideas as partial motivators of human action. Ideology is defined by North (1981:48) as *'intellectual efforts to rationalize the behavioral pattern of individuals and groups'*, an effort to link facts to meaning. Ideologies have certain properties. First, they are 'economizing devices' that provide individuals with ways of sorting information and draw intuitive conclusions from it; decision-making becomes cheaper. Second, it contains moral and ethical judgments about such things as the fairness of the current distribution of income and what a more proper distribution would be. Ideologies as such induce our personal judgment about the overall legitimacy of the current property rights regime and wealth distribution. Third, not one, but many contradictions of experience and ideology must accumulate for an individual to change her ideology. For institutions and economic development, North (1981:55) claims that investment in legitimizing the appropriate institutions by the principals is essential to constrain the contracting parties. An illustrative example of such efforts are ideological rectification campaigns of the CCP in the reform era that stressed pure communist values in an era of growing opportunities to derive gain from public office. The lack of institutions (such as free courts and media) to constrain corruption amongst party officials however amounted to incentives that were too strong to be countered by ideological preaching from above (North 1990:132).

The role of ideas, particularly an ethic that values hard work not for the results it brings but as a good in itself, is Martin Luther's idea of 'the calling'. Max Weber's (1930:79) Die *Protestantische Ethik und der Geist des Kapitalismus* from 1905 implies that ideas to some degree induce incentives. More specifically, Protestant religious ideology, especially Calvinism, was in symbiosis with hard work, reliability and honesty that was essential to the development of successful business. Weber (1930:35) supports this with data suggesting the prominence of Protestants over Catholics in the business life of the day in Germany, and rules out the possibility of it being a result of circumstance. From generally looking at history we can also conclude that Protestant parts of Europe developed Capitalism and the rule of law earlier than Catholic parts.

In the case of ideology in this sense in today's Kunshan it would amount to a reduction in transaction costs for doing business in Kunshan if the city would sponsor certain ideological values among its agents (bureaucrats, cadres) similar to that discussed first by Max Weber.

Institutions and historical differences in economic performance

So far, this is a story about how states are defined by their institutions, most notably property rights. The purpose of institutions is to reduce uncertainty in human interaction, and in doing so to a varying degree realize gains from increasing division of labor and trade. We have also seen that some scholars argue that ideas and norms play a role in sustaining institutions or helping certain institutions grow. Moreover, changing relative prices of labor, capital, land and technology are described as the root causes of institutional change.

Douglass North sums up economic history from the age of hunting-gathering as a gradual development and growth in the size of markets and accompanying division of labor, from more or less exclusively agricultural societies to today's urban economy of exponentially expanding numbers of transactions between people all over the globe. In terms of jobs, it is a story of farming to a growing service sector of the economy that exclusively specializes in reducing transaction costs. The expansion of trade has brought with it increasing transaction costs, as dense social ties that used to make markets on small scales predictable are not possible in trade on a growing scale. From medieval times onward in Europe institutional innovations were deceived that reduced transaction costs, mainly in three areas. Capital became more mobile as bills of exchange and new merchant accounting methods developed. Information costs were reduced as printed information of prices, measurement scales and exchange rates between monies became widespread. Finally, the means of spreading risks developed, such as more effective ways of ensuring naval merchant trade (North 1990:125-127).

If states are defined by the property rights they uphold, they differ since they reacted to these developments in different ways. In early modern times as we have seen, relative prices changed in that military technology suddenly required sovereigns to field large, standing armies. Spain, the most powerful empire in Europe during the 16th century, failed because of the arbitrary nature of its extraction methods (selling tax-exempt noble status, granting more monopolies to guilds in towns, and straightforward confiscations) increased transaction costs and erased incentives for productivity increases and investments. In time this led to rebellion, six state bankruptcies and the inability to sustain qualitative armed forces. A similar situation with guild monopolies for crown revenue existed in France. The Netherlands, and later England, differed. The 17th century in England with constant conflict between the crown (like its counterparts prone to grant monopolies) and parliament had as its chief result the shackling of the sovereign under the law. The parliament was then on a more equal footing with the royalty than in Spain or France. Merchant interests where represented, and this lead to more secure property rights and curtailment of crown-granted monopoly rights (North 1981:151-157).

Under relatively secure property rights and no overwhelming center of political power to arbitrarily change property rights, England could develop capital markets that functioned both to finance private commerce but also as a means for a financially solvent government to acquire loans to lower interest rates (virtue to the fact that the risk was lower) for military or other needs (North 1990:139-140). The different paths of development that England and Spain represent underscore the central importance of predictable (in the best case law-bound) government.

The development of a court system (relatively) independent of the sovereign led to a closer relationship of private and social benefits of industry and commerce, which as we have discussed above is the key criterion for what is to be considered ‘efficient’ institutions. The institutional environment was replicated in the colonies of England and Spain and its general implications for sustainable economic growth are evident, as seen in Hernando De Soto’s (2000) well-known study of how path-dependent the historical development of property rights was in the west and the prospects for such rights in the third world today.

Institutions and modern differences in economic performance

How then do we relate economic history to our story of institutional frameworks for economic development in the modern world? We have seen that the English example of a divided state, combined with political representation for commercial interests, led to economic growth. This might lead us to conclude that the weaker the state's influence over society is and weaker its capacities, the better for society. Douglass North's economic history has been a story of how relative prices changes institutions - political, economic and social. On the other hand, Normative institutionalists such as March and Olsen emphasized the autonomy of the state from society and norm-creating functions of state institutions. Other scholars on the same line emphasize state autonomy, capacity and symbiotic (as opposed to predatory) links to society as the very definition of state strength. Weiss-Hobson (1995:2) suggests that state strength is a differing concept over time. They believe that while historically, extractive power and territorial would suffice; today the state must play an active role in providing a 'central coordinating intelligence' for industrial and technological planning. They also note that strong states historically are the most deeply connected amongst its social base – this is central to their extractive capacity as they rely less on despotic measures and arbitrary exercise of power (Weiss-Hobson 1995:4). Their power and capacity can thus be called negotiated, infrastructural or embedded. So far the argument is in line with North's comparison of early-modern European states. Weiss-Hobson then bring in the coordinating capacity of the state – its ability to 'govern the market' – as the central explanation to the fast development of Japan and subsequently the four dragons Korea, Taiwan, Hong Kong and Singapore. They suggest that in these states, major social groups and the state shared what Peter Evans (1995:47) called a 'joint project' for development. The secrets to the strength of East Asian developmental states reside in

…their unusual combination of bureaucratic autonomy and collaborative linkaging with the economic sector (infrastructural tinge). (Weiss-Hobson 1995:162)

Peter Evans, doing a comparative study of Korea, Brazil and India on the state's role in economic development, classifies states on a scale from predatory to developmental. He similarly argues that:

The trick is to establish a connection between developmental impact and the structural characteristics of states- their internal organization and relation to society. (Evans 1995:12)

To establish this connection Evans introduces two variables, Autonomy and Embeddedness. It is suggested that high values of both in state organizations are what enable sustainable economic growth. Evans especially stresses that a state must possess both of these properties to be called developmental. Only autonomy would lead to policies disconnected from real needs and plans developed by individuals and organizations in society, while only embeddedness could lead to state capture by interest groups for private gain. These two variables merit a closer look, since they are important underlying parts of the field research for this thesis.

Autonomy

In this thesis, I propose to measure state autonomy according to two variables – **bureaucratic capacity** and **bureaucratic integrity**. What this means is that an autonomous state has both the knowledge and organization that allows it to pursue its own policy goals, and the cohesiveness, credibility and integrity in the work of state bureaucracy that does not leave individual office-holders free to use their position for personal gain (corruption). These two are distinct qualities, but they positively reinforce each other. A bureaucracy can be endowed with both well-educated personnel, a large budget and far-reaching legal rights – but still be undermined by individual abuse of power. A bureaucracy can also (more likely in established democracies with strong legal cultures) be relatively free from corruption but at the same time lack the funding, legal rights or personnel resources enabling it to be effective in whatever it is tasked to do. Peter Evans writes: "*To deliver collective goods, states must act as coherent entities. Institutionalized bureaucratic power keeps individual incumbents from peddling rules* *and decisions to the highest bidder. Being a coherent actor involves more than just reining in the greed of individual officeholders, it involves entrepreneurship as well. Developmental states help formulate projects that go beyond responding to the immediate demands of politically powerful constituents."(1995:248)*

Autonomous state bureaucracy is based on strongly selective, meritocratic recruitment and provides long-term career prospects. High salaries are one component, participation in informal networks were membership is based on clear evidence of extraordinary educational and professional merit is another, that grants a glimmer of high status to bureaucratic careers. Such factors ensure loyalty and coherence in the corps and enhance solidarity between its parts.

Ideology is another key component. Peter Evans (1995:58) uses the word 'Weberian' to describe autonomous bureaucracy as a way to emphasize the importance of ideology in its undergirding – the bureaucrat is hindered not only by factors such as high salaries and high-status networking but also by socialization and *espirit de corps* from degenerating into a stationary bandit.

Japan is a case in point. Weiss-Hobson (1995:162) describes Japanese post-war officialdom as subjected to rigorous and predictable recruitment and promotion procedures. The stability of the 'rules of the game' inside the bureaucracy allowed bureaucrats to take long-term perspectives on economic growth – which they did, since a perceived geopolitical vulnerability and the desire to catch up with the west after a disastrous war led Japan to formulate a developmental project in terms of national security. MITI, the Ministry for Trade and Industry, stands out in this regard. Having achieved rights for 'strategic' intervention in various industries, MITI wielded powerful incentives such as control of state credit allocation, licensing of who was to be allowed to import foreign technology, tax breaks and settings up overt cartels to regulate competition in an industry. MITI, in the eyes of some observers, was a collection of bureaucratic power, talent and prestige. A MITI job was the number one career dream of the best and the brightest from the country's best universities. This was ensured by the tough higher civil service exam, where only 2-3 percent in any year would pass (Evans

1995:48). A career in MITI was virtually ensured life-time employment with clear standards and rules for desired bureaucratic behavior, so the incentives facing each employee were in favor of self-maximization through the system.

Evans (1995:51-53) writes that in Korea, there is at least 1000 years of tradition regarding meritocratic civil service examinations. Like in Japan, only a few percent of those who take it are accepted. In other respects, Korea is also very similar to Japan; a corporate culture of coherence, high social status, long-term career opportunities. The exception that seems to confirm this rule is the Rule of President Rhee (1948-1960). Rhee, who depended on clientilistic ties to business to finance his political life, set aside the rules and used political appointments. It hardly needs mentioning that rent-seeking was severe during this time. The military coup of 1960 broke with the pattern of most military coups around the world and actually restored meritocracy in the Korean higher civil service.

Evans (1995:54-55) further exemplifies that Weber's insistence on non-political, meritocratic and high-social status bureaucracy is confirmed also by Taiwan, where technocrats (with engineering background from National Taiwan University) staff various bureaucracies.

In sum, autonomous bureaucracies are effective because they can keep the organization working towards one, centrally agreed, direction – and are able to do so because they are endowed with the necessary resources.

Embeddedness

Peter Evans defines embeddedness as *"…a concrete set of connections that link the state intimately and aggressively to particular social groups with whom the state shares a joint project of transformation."* and *"…a concrete set of social ties that bind the state to society and provide institutionalized channels for the continual negotiation and renegotiation of goals and policies."* (1995:59)

For this thesis, I propose using two variables to indicate embeddedness. First, **business organization** in civil society. This means investors working together in a civil society capacity to realize benefits of scale in information, lobbying and social service provision, to name a few functions. Normally in China, the state strongly discourages civil society and prefers it disorganized since a disorganized civil society is a threat to one-party rule. However, in this case the embeddedness of the developmental state requires some type of civil organization of business interests to "partner" with the government. Second, **business-bureaucracy connectedness** can be more or less pronounced depending on how much importance the local government places on the opinions, advice and suggestions they obtain from business organizations.

Embeddedness is necessary for a state with developmental ambitions because there is a considerable amount of relevant information for their development policy that can only be obtained from practical knowledge of business interests. The argument goes that if a market economy is a decentralized process of exchange where actors are guided by the information contained in fluctuating prices, and each price represents a complex set of productive relations and relative prices, this tells us that all actors must constantly adjust their actions and future plans according to this information. Since the vast majority of information is only available to certain people and limited in its use in time and space, a rational economic order requires an 'order', a legal framework if one wills, that enables society to use as much of this elusive information as possible. A state that wants to centrally plan an economy must collect and process this information – an impossible task. This problem is known to economists as the 'information problem' – the primary reason why central planning failed wherever it was attempted, according to Hayek (1945).

Max Weber's autonomous bureaucracy by itself does not assure successful policy implementation. First, the bureaucracy might be Weberian but at the same time try to implement a central-planning policy – the post-independence Indian fallacy, discussed by Evans (1995:67-68) at length. The Indian 'License, Permit, Quota Raj' did not fail because of lack of professional bureaucracy, where India has traditions similar to those of Korea since the Mughal Empire. Such a system fails to use the decentralized knowledge of society – it is detached from rather than embedded in society. The second piece of the puzzle as regards the success of Japan, Korea and Taiwan is related to the way they have systematically attempted to get around the information problem by building overarching policy networks and consultation bodies with society to collect information and adjust plans and policies according to the problems and economic realities faced by firms.

This sounds paradoxical as we have seen how theory has warned of corruption and clientilism resulting from close state-business ties. North's argument was that such relations ended up granting special protection and privileges to businesses and least of all promote economic growth. It is however hard to misjudge the enthusiasm with which bureaucracy-industry ties are described in accounts of East Asian development. Weiss-Hobson for example argue that a true developmental state combines autonomy with embeddedness, and that the politically insulated, weberian bureaucracy has formed dense ties to industry associations and firms in a way to include and make them active stakeholders in the state's project of economic transformation. Routinized exchanges between state and society in this way is tricky as it risks compromising autonomy, but at the same time a bureaucracy that stays behind its desk is completely unable to bring about economic transformation. This relationship involves a different kind of state power than the state simply ordering society what to do. It is a "negotiated" power of a collaborative nature. It differs from despotism in that it is perceived as more legitimate and therefore gains a much stronger capacity both in networking and penetrating into society to gain much-needed relationships and information, as well as its ability to direct societal resources to a 'greater' political goal which can be development, conscription, welfare, taxation etc. In numbers, it is this penetrative capacity that traditionally has set Britain apart from more primitive and despotic states such as Russia and China. Between 1715-1850 Britain managed to extract around 10% of GDP in indirect taxation, and finance military expansionism through credible action on the financial market (as opposed to simply expropriating resources as needed). Weiss-Hobson (1995:112-117 and 167-169) argues that British power was 'negotiated' and thus more legitimate and effective than ad-hoc despotism in Russia and China. This suggests that it is not enough to simply allow business to organize in civil society but also that the state must be willing to seriously consider business interests as legitimate and sometimes adapt political decisions to those interests.

What Japan and the NIC's did was that they, in different ways, integrated business in the decision-making and obtained both information and cooperation from business by institutionalizing cooperation in state-sponsored industrial associations, policy consultation bodies and export cartels (Weiss-Hobson 1995:170). It should be pointed out that this is not a perfectly harmonic relationship, free from friction or conflict. Rather, Weiss-Hobson (1995:169) describes it as simply a 'basic agreement between two or more parties for advancing common interests'. The rules for establishing and maintaining interdependence have to be constantly re-negotiated, where the state is not in a position to order society around but rather play the role of a 'senior partner'.

Weiss-Hobson (1995:178-179) asserts that the translation of autonomy into capacity through embedding bureaucracy in the consultative partnership with business has led to two primary results. One, the political-economic policy making exhibits a democratic deficit. Two, the information problem is dealt with, naturally not perfectly but at least much better than in say India or Brazil. A democratic deficit here refers to the lack of public insight into the political economy of government-business relations and thus the relative lack of special-interest lobbying as we would be able to observe in Washington and Brussels. Since economic policy is set by non-political (as in the meaning of non-politicized) bureaucracy, special interests lack influence and it is possible to design flexible yet long-term policies with direct input by the sectors the policies concern. As regards the information problem, the think-tank role played by insulated bureaucracy due to the flexibility and ease with which they obtain updates from industry on their future planning makes smooth adaption possible even if it is impossible to resolve the information problem completely.

Peter Evans (1995:50) argues that the Weberian autonomous bureaucracy is to be understood as a requirement to take part in the industrial networking and innovation process (as this requires specialized knowledge not found in a typical third world bureaucracy) but also as the only guarantee against capture by special interests in that process. Even if Japan's MITI is once again held as the archetype, Korea and Taiwan, albeit with more autonomous states than Japan (in a stronger position vis-à-vis industry) are other cases.

Hypothesis

I have discussed what institutions and what type of political organization is compatible with sustainable economic development. I have also discussed what the circumstances are under which institutional change takes place. In short, it is assumed that changing relative prices, for example sudden access to foreign capital, which was the result of China's "open-door" policy, will result in institutional changes. This will however not happen overnight. Instead, the new economic opportunities will, through investment, start a mutually reinforcing process in which the local government gradually reforms itself along with gradual economic transformation. Investors bring with them knowledge and expectations of government behavior based on experiences from their home and other countries, and they teach the local government how they should operate to successfully continue their economic transformation. In a local institutional environment where neighboring counties and cities adapt in order to attract even more FDI, in ever more advanced and competitive industries, increasing the embedded autonomy of the local government in order to be able to make future institutional adjustment to counter efforts of competing local governments to lure away investors becomes key to survival. Embedded autonomy should thus strengthen the reputation of a locality for good governance and thus lead to even more investment, reinforcing the whole circle.

To verify the hypothesis, we must verify that the variables making up embeddedness, autonomy and economic transformation increase at the same time. I explained above what I mean by Business organization, Bureaucracy-business connectedness, Bureaucratic capacity and Bureaucratic integrity, and will attempt to argue them all in the case study below based on my interviews.

I have chosen to base "economic transformation" on a wider measure than just GDP growth. Changing industrial structure is measured by the size and growth of agricultural, manufacturing and service sectors, respectively. This is informative since it tells us how far down the road of economic transformation a society is – from agricultural to manufacturing to service sector dominance in value and workforce. Globalization is measured by reliance on foreign trade and the level of Foreign Direct Investment (FDI). Lastly, increasing private welfare is measured by average disposable incomes and the consumption of non-durable goods and private investment in durable goods.

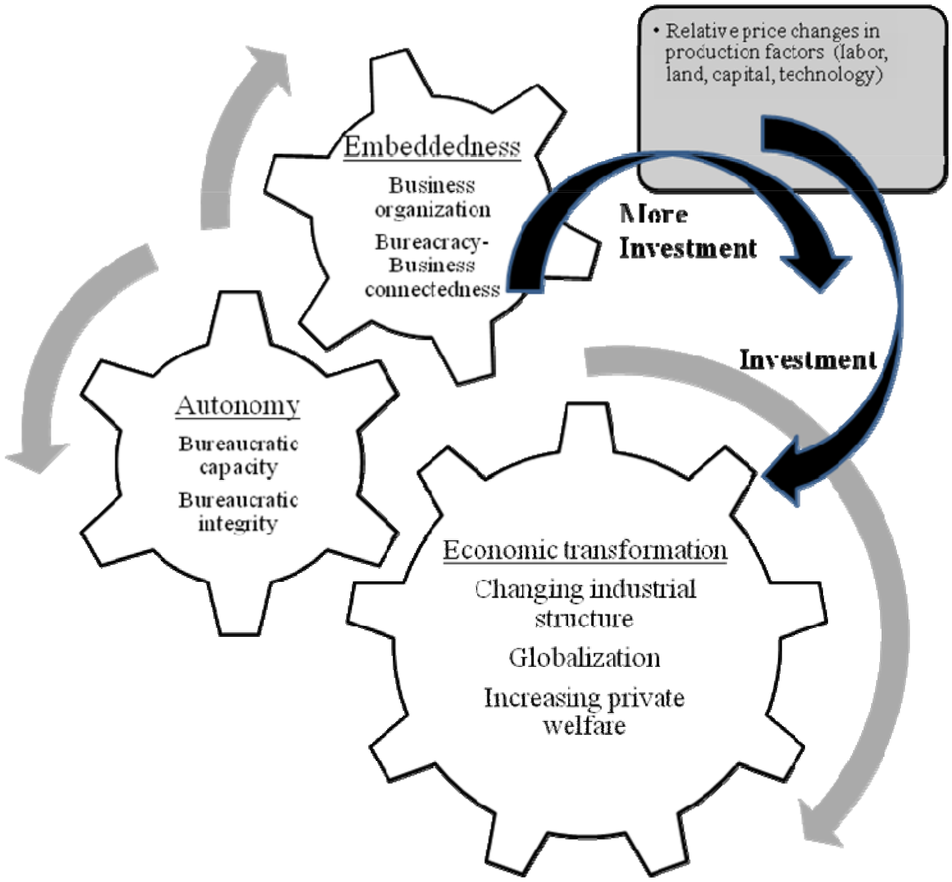

Figure 1. Summary of analytical model/hypothesis. Changes in relative prices make possible initial investment, which starts a process of economic transformation which co-varies with strengthening embedded autonomy. Strengthened embedded autonomy then leads to more investment, further reinforcing the process.

Chapter 4: The Kunshan Case

The surveyed literature establishes a clear connection between the performance of economies and the incentives, rules and norms guiding individual behavior (fixed in law