

Institutional Change, Polycentric Governance and Economic  
Performance: The Case of China in Transition

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## Abstract

China has been in transition from a totalitarian regime to a market economy, a civil society, and a political state. This article puts forth a constitutional framework of polycentric governance with a double-loop learning system of institutional change to achieve a better understanding of the transition. A polycentric pattern of governance has emerged on the basis of a factor analysis of the census data of corporate entities in transitional China. And the economic performance of polycentric governance is evaluated by a canonical correlation analysis. The findings show that the market governance of enterprises resulted in large economic wealth, small government size, and low income gap between urban and rural areas in a time of transition; the social governance of non-profit organizations and associations related to small government size; and the state governance of governments and communities did not bring about large economic wealth and low income gap through big government size until 2008. To conclude, polycentric governance is conducive to economic development.

Keywords: institutional change; polycentric governance; economic performance; corporate entity; China in transition

## 1. Introduction

“Taking class struggle as the key link” was replaced by “promoting economic development” as the central task of the Communist Party of China (CPC) at the Third Plenary Session of the 11<sup>th</sup> National Congress of the CPC in 1978, which was later written in the 1982 Constitution. The reform and opening up policy made accordingly started in rural areas with the family-based contractual scheme of the collective-owned arable land. Since the incentive mechanism works with the significant increase of agricultural productivity (Lin, 1992), industrial reforms in urban areas followed suit in the mid-1980s stripping off the governmental and social functions of the state-owned enterprises (SOEs) and letting other types of enterprises grow (Naughton, 2013). Reforms never go smoothly, and the ideological tension of the leftists and the rightists has been there. Deng Xiao-ping, the chief designer of the reform and opening up policy, advocates the pragmatic guidance principle of “seeking the truth from facts” to resolve dispute.

The 14<sup>th</sup> National Congress of the CPC in 1992 decided to establish a socialist market economy going beyond the argument that only capitalism has market economy. While the 1988 Constitutional Amendment calls for the expansion of private economy, the early stage of the Chinese socialism was concluded in the 1993 Constitutional Amendment and its main goal is set to develop a market economy. China in transition is characterized with the constitutionalization of key reforms. To have market work productively, the state intervention in the economy and society should be limited. The 15<sup>th</sup> National Congress of the CPC in 1997 agreed to set up the rule of law for the state administration that was written in the 1998 Constitutional Amendment. Given the market determinant of economic development, protecting property rights is eventually written in the 2004 Constitutional Amendment.

Thanks to the reform and opening up policy, China is now the second largest economy and the first largest country of foreign trade in the world. It is time to evaluate the transition and its impact on economic development for knowledge gains and policy transfer. Drawing on new institutional economics and constitutional political economy (Coase, 1998; North, 1990; Buchanan, 1989; Ostrom, 2008; Ostrom, 2005), this article puts forth a constitutional framework of polycentric governance with a double-loop learning system of institutional change. It is then applied to explain the emerging polycentric pattern of governance in transitional China with the census data of corporate entities. Moreover, the derived hypothesis that polycentric governance leads to better economic performance is empirically tested.

## 2. A Constitutional Framework of Polycentric Governance

What are institutions? Institutions are informal and formal rules with enforcement

mechanisms of monitoring and sanctions that are able to constrain and/or enable collective and individual actions (Hodgson, 1988; North, 1990; Ostrom, 1990). Informal rules in terms of habits and norms are related to civil society, formal rules in terms of constitutions and laws are related to political state, and the mixed rules in terms of property rights are related to market economy. Market economy is embedded in both civil society and political state (Granvovetter, 1985; Evans, 1995), as Figure 1 illustrates. Today, we are all in the age of globalization, the sovereignty of nation-states has been hollowed out through reallocating the central power of the state upward to international organizations, downward to localities and communities, and sideways to private and third sectors (Hooghe and Marks, 2003). The multi-level and polycentric pattern of governance would emerge to cope with globalization. With the rise of civil society worldwide (Salamon et al., 1999), the trichotomy of the state (government), market (economy), and civil society has superseded the dichotomy of government and market that dominates mainstream economics (Martinussen, 1997; Triglilia, 2002; Burawoy, 2005).

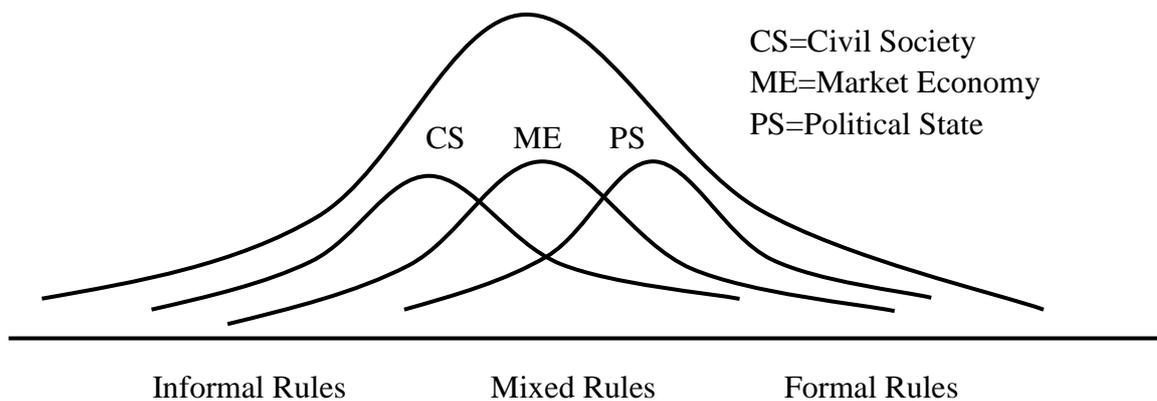


Figure 1. A Constitutional Framework of Polycentric Governance  
Source: Adapted from Zhang, 2005: 202.

The partnerships between the state, the economy, and the society are emphasized here, demonstrating the institutional fragmentation and overlapping structure shown in Figure 1. The partnerships suggest the polycentric governance of corporate actions derived from the separation and combination of the state, the economy, and the society as legal or corporate persons according to the principal-agent theory of property rights. James Coleman (1994) argues that there are two selves in a body, one is principal, and the other agent; if the two are not in one body, a fundamental corporate action is thus formed. Hence the corporate persons of the state, the economy, and the society can be separated and then combined to form nine ideal types of corporate actions that are governments, private enterprises, voluntary associations, SOEs, natural monopolies, governmental NPOs, communities, social enterprises, and non-governmental NPOs, as summarized in Table 1. The nine ideal types in reality can be reduced by combining similar terms to five ideal types that are governments, enterprises, NPOs, communities, and associations. Moreover, governments may

represent the state, enterprises the economy, and associations, NPOs, and communities the society.

Table 1. Nine Ideal Types of Corporate Actions

		Principal		
		The state	The economy	The society
Agent	The state	Governments	Natural Monopolies	Communities
	The economy	State-owned Enterprises	Private Enterprises	Non-governmental NPOs
	The society	Governmental NPOs	Social Enterprises	Voluntary Associations

Note: NPOs refer to non-profit organizations.

Corporate actions are self-organized, as prescribed by the congruence theory of goods and providers shown in Table 2. Goods are classified as four types, which are: (1) private goods, excludable in use and rival in consumption; (2) public goods, non-excludable and non-rival; (3) common goods (common-pool resources), non-excludable and rival; and (4) club (toll) goods, excludable and non-rival. Vincent and Elinor Ostroms (1971, 1977) argue that public choice is not restricted in the dichotomy of states and markets; states or governments provide public goods productively, while markets or enterprises do private goods productively. They expand public choices and explore alternative institutional and organizational arrangements in the provision of public services (Ostrom, 2010; McGinnis and Ostrom, 2011). Beyond the dichotomy of states and markets, empirical studies show that communities are good at the provision of common goods, and NPOs and associations are good at the provision of club goods (Ostrom, 1990; Salamon, 1995; Salamon and Anheier, 1996).

Table 2. The Congruence Theory of Goods and Providers

	Excludable	Non-excludable
Rival	Private goods  Enterprises	Common goods  Communities
Non-rival	Club goods  NPOs and Associations	Public goods  Governments

The congruence theory of goods and providers reveals the division of labor among political state, market economy, and civil society, i.e., self-organizing efficiency in providing public services. Provided a holon represents the congruence of a type of goods and a type of providers, the four holons together may scale up and down to constitute a holarchy or a polycentric order of corporate actions, in which economies of scale and scope are the organizing principles. Specifically, corporate

actions may express nested institutional and organizational arrangements on the basis of the economy of scale, where local corporate actions provide goods with small externality, and national or global corporate actions do ones with large externality. And policy networks of stakeholders may include non-nested institutional and organizational arrangements of corporate actions that are usually based on the economy of scope.

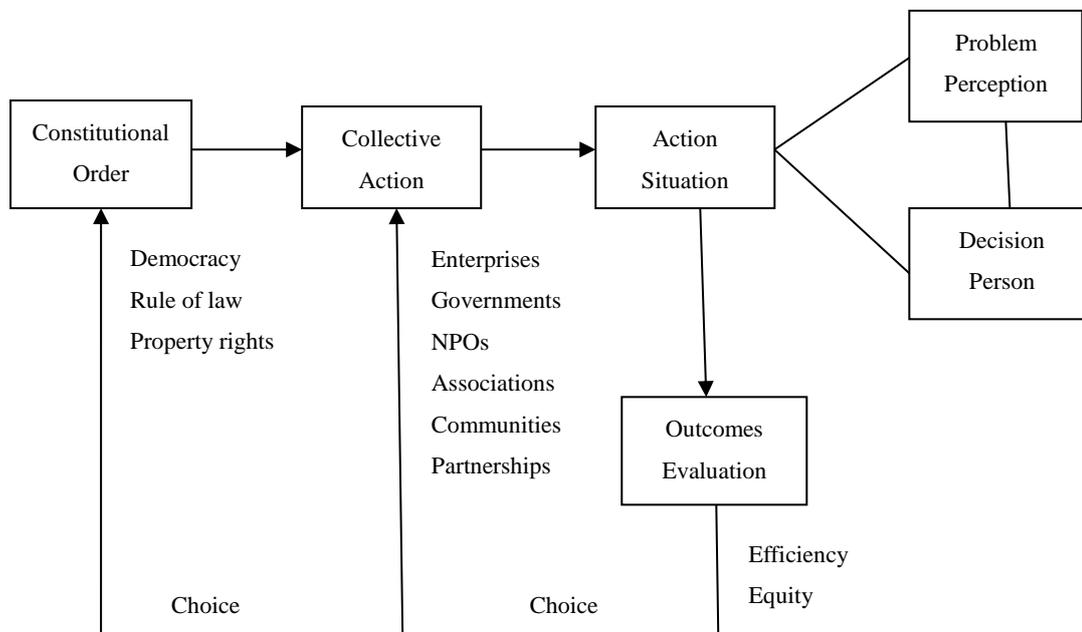


Figure 2. A Double-loop Learning System of Institutional Change  
Source: Adapted from Ostrom, 2005: 214

How do institutions of corporate actions evolve? Elinor Ostrom (2005) puts forth operational, collective-choice, and constitutional-choice levels of analysis. James Buchanan (1989) distinguishes constitutional choice from collective choice, and the former is to choose the rules of the game while the latter is to choose collective actions within the rules of the game. By the same token, Oliver Williamson (1996) provides an analytic framework of corporate governance embedded in its institutional environment. Figure 2 shows a double-loop learning system of institutional change adapted from Elinor Ostrom (2005), in which a decision person with rationality makes constitutional and collective choices given an action situation. The constitutional choice is to set up the institutions of property rights through the rule of law and democracy for corporate actions, and the collective choice is to arrange a type of providers for a type of goods according to the congruence theory of goods and providers. All institutional changes are made on the basis of the rational evaluation of corporate or collective actions with the criteria of efficiency and equity.

### 3. China in Transition from a Totalitarian Regime

Unlike the radical reforms of the former Soviet Union and Eastern Europe, the incremental reforms in China are characterized with the corporatization of economic, social, and even political organizations in accordance with the General Principles of the Civil Law issued by the National People's Congress in 1986. If the institutions of a market economy are regarded as contractual arrangements between equal subjects for exchange, civil law as the third party enforcement mechanism stipulates the civil rights and liabilities of the two contractual subjects, given the equal subjects holding legal and/or natural personality. Corporatization simply means the state recognition of corporate actions as legal or corporate persons. According to the Census Center of the National Bureau of Statistics of China, six types of corporate persons are categorized, which are governments, enterprises, communities, associations, public institutions as governmental NPOs, and private non-enterprises as non-governmental NPOs. Governments, composed of all organizations of political parties, legislature, bureaucracy, and judiciary from national to local, need not go for registration and naturally become corporate persons.

Communities as corporate persons are represented by rural villagers committees in accordance with the Organic Law of the Villagers Committees issued in 1987 and urban residents committees in accordance with the Organic Law of the Urban Residents Committees issued in 1989. Direct democracy in China refers to the grass-roots democracies in terms of community self-governance. Politically, grass-roots democracies signify villagers committees and residents committees whose members are elected directly by citizens in rural and urban communities. In rural communities, there are communist party committees in parallel with villagers committees, whose members are elected directly by party members of villages, and the two committees work together to promote economic development and provide community public services such as preschool and primary education, home-based care for elders, community policing, and environmental sanitation. By comparison, residents committees in urban communities are elected directly by residents but guided indirectly by the street-level bureaucracy to provide community public services for their residents.

Enterprises as corporate persons are made up of all kinds of enterprises in accordance with the Regulations on the Registration of Enterprises as Legal Persons issued in 1988 and the Regulations on the Registration of Companies issued in 1994. Generally, enterprises in China are categorized as SOEs, collective-owned enterprises, cooperative enterprises, joint ownership enterprises, limited liability corporations, share-holding enterprises, private enterprises, foreign enterprises, Hong Kong-Macao-Taiwan enterprises, social enterprises, and others. Empirical studies indicate that the emerging non-state sector driven by the small and medium enterprises contributes more to economic growth than the state sector (Lin and Zhu, 2007). Nevertheless, phasing out the favorable policy for foreign enterprises, Hong Kong-Macao-Taiwan enterprises, and SOEs has been the public demand for fair competition between enterprises in a market economy.

NPOs as corporate persons consist of all organizations either as public institutions in accordance with the Interim Regulations on the Registration of Public Institutions issued in 1998 or as private non-enterprises in accordance with the Provisional Regulations on the Registration of Private Non-Enterprises issued in 1998. Public institutions are resulted from the centrally planned economy of China acting as public sector. To adapt to civil society, public institutions have been transformed to become governmental NPOs. And private non-enterprises as non-governmental NPOs are allowed to boom. Public institutions and private non-enterprises are complementary rather than competitive in delivering public services such as education, culture, research and development, health care, social services, environmental protection, economic development, civil advocacy, and charity.

Associations as corporate persons are created in accordance with the Regulations on the Registration of Social Organizations issued in 1998 including academic associations, professional associations, civic associations, trade unions, and foundations. It is voluntarism that lays the foundation for associational life of civil society. Yet associational life in China was co-opted by the state through the dual administration of registration and affiliation. Specifically, to register as a corporate person, an association has to be affiliated to an administrative unit in advance. The dual administration of associations has been criticized to discourage the development of civil society. The good news is since March 1<sup>st</sup>, 2014 to find an administrative unit affiliated is not necessary for these types of associations such as industry and commerce, science and technology, public interest and charity, and community services to register as corporate persons.

The institutional and organizational differentiation between the state, the economy, and the society is the characteristics of China in transition from a totalitarian regime. Good governance indicates a polycentric order of diverse corporate entities resulted from the rule of law and democracy. Democracy facilitates the self-governance of economic and social organizations, while the rule of law limits the state intervention in the economy and society. The political democratic system of China in transition features the People's Congresses and the Political Consultation Congresses from local to national led by the CPC as the ruling party. Delegates of the People's Congresses at the level of county, district, and township are elected directly by their constituents, and they vote for the provincial delegates who then vote for national delegates. In contrast, delegates of the Political Consultation Congresses at all levels are politically appointed on the basis of proportional representation of political parties and functional organizations. All political power comes from the People's Congresses through political consultation with the Political Consultation Congresses. The President of the state, the State Council as the executive branch, and the Judiciary are legitimately derived from the National People's Congress. And heads of provincial and local governments are respectively elected by the People's Congresses at provincial and local levels.

How are governments organized? Fiscal federalism may be the answer. The core of fiscal federalism lies in the principle of fiscal equivalence, which means that the boundary of taxation should be the same with government expenditure (Olson, 1969). The unitary system of governments in China is not a monolithic whole, and has taken on the *tiao-kuai* system, the quasi-federal or matrix arrangements of the state administration. The term *tiao* refers to the vertical lines of authority over various sectors reaching down from ministries of the central government, while the term *kuai* refers to the horizontal level of authority of the territorial governments at the provincial or local level (Lieberthal, 1995). For example, a local environmental protection bureau may have reporting responsibilities to both the Ministry of Environmental Protection and the mayor of the city where it is located. And a big step towards a fiscal federal system is the 1994 tax division between central and local governments. Since then the central government takes away a larger share of the total tax revenue for welfare spending equalization across localities by central transfer payments, while the local governments has mandatory responsibilities for the provision of local public services.

Beyond reinventing the state administration, the transition from a totalitarian regime characterizes the corporatization of political, economic, and social organizations. As for the 2001 census data, the total number of corporate entities is 5,107,015, in which the number of governments is 307,011, the number of NPOs combining public institutions and private non-enterprises is 834,921, the number of enterprises is 3,025,862, the number of communities is 832,941, and the number of associations is 106,280. As for the 2008 census data, the total number of corporate entities is 7,098,765, in which the number of governments is 249,670, the number of NPOs is 861,245, the number of enterprises is 4,959,671, the number of communities is 841,090, and the number of associations is 187,089. Thus, the average annual growth rate of the total number from 2001 to 2008 is 4.8, the average annual decrease rate of governments is -3.0, the average annual growth rate of NPOs is 0.4, the average annual growth rate of enterprises is 7.3, the average annual growth rate of communities is 0.1, and the average annual growth rate of associations is 8.4.

Corporatization across regions and over time has taken on an institutional isomorphic structure of diverse corporate entities through the coercive, mimetic, and normative mechanisms, as seen in Table 3, according to the theory of institutional isomorphism (DiMaggio and Powell, 1983). The coercive mechanism conveys a top-down approach to the registration of corporate entities. The registration regulation is regarded as a national law and should be implemented uniformly across regions. The mimetic mechanism refers to a bottom-up approach, through which one region learns from other regions how to register a corporate person. Obviously, there is a catch-up effect of institutional isomorphism over time in light of coefficients of variation in Table 3. Finally, the normative mechanism fosters corporatization through the flows of professionals across regions that may bring about the structural

consistency of institutional arrangements of corporate actions.

Table 3. Institutional Isomorphism of Corporatization (%)

	Governments	NPOs	Enterprises	Communities	Associations
2001					
National	6.01	16.35	59.25	16.31	2.08
Mean	8.14	17.62	52.65	19.31	2.29
S.D.	5.02	7.14	18.11	10.09	0.75
C.V.	0.62	0.41	0.34	0.52	0.33
2004					
National	4.57	14.54	62.87	15.99	2.03
Mean	6.70	16.71	55.16	19.05	2.38
S.D.	4.97	6.91	17.83	9.53	0.93
C.V.	0.74	0.41	0.32	0.50	0.39
2008					
National	3.52	12.13	69.87	11.85	2.64
Mean	5.39	14.32	62.22	14.81	3.26
S.D.	4.53	5.74	16.91	8.17	1.52
C.V.	0.84	0.40	0.27	0.55	0.47

Note: S.D. denotes standard deviation, and C.V. does coefficient of variation.

Source: Census data from the National Bureau of Statistics of China.

#### 4. Polycentric Governance and Economic Performance

The polycentric structure of the distribution of corporate entities was further analyzed through a factor analysis. The factor loadings matrix of a two-factor solution manifests the three dimensions of institutional change of transitional China, as summarized in Table 4. The first factor represents the market-economy-oriented institutional change, in which enterprises are structurally singled out from other corporate entities, for enterprises as for-profit organizations are the subjects of market economy and the engine of economic growth. And meanwhile the second factor exposes not only the civil-society-oriented institutional change in terms of the clustering of NPOs and associations but also the political-state-oriented institutional change in terms of the clustering of governments and communities. The three dimensions of institutional change in China have been studied qualitatively rather than quantitatively (Urio, 2011; Rosen and Gries, 2011). Just as Ferdinand Tonnies (1957) argues for the conceptual separation of community and society, the community as a territorial entity is related to communal life, while the society as a functional entity is to associational life. Civil society in a narrow sense should not include communities, and the territorial communities in accordance with gross-roots democracies should be included in the domain of political state.

Table 4. Factor Loadings Matrix

	2001		2004		2008	
	Factor 1	Factor 2	Factor 1	Factor 2	Factor 1	Factor 2
Government	0.92	-0.25	0.87	-0.35	0.85	-0.44
NPO	0.59	0.61	0.64	0.64	0.76	0.47
Enterprise	-0.99	0.05	-0.99	0.04	-0.99	0.06
Community	0.86	-0.45	0.87	-0.40	0.91	-0.29
Association	0.52	0.60	0.64	0.45	0.73	0.46
Eigenvalue	3.19	1.00	3.30	0.89	3.67	0.72

*Source:* Census data from the National Bureau of Statistics of China.

Does polycentric governance cause the better economic performance? Before starting a canonical correlation analysis, it needs to look at the economic performance of transitional China first. Table 5 shows the three chosen indicators in 2001, 2004 and 2008 that are regional GDP per capita as the indicator of economic wealth, regional income ratio of urban to rural as the indicator of distributive justice, and regional public expenditure share in regional GDP as the indicator of government size. While the average annual growth rate of economic wealth from 2001 to 2008 was 14.8% without considering inflation, distributive justice across regions got worse from 2001 to 2008, given the almost unchanged size of government through time. Moreover, economic wealth and government size held larger regional disparities, and there was less difference across regions in distributive justice, according to the coefficients of variation in Table 5.

Table 5. Economic Performance of Transitional China

	2001		
	Economic Wealth (RMB yuan)	Distributive Justice (ratio)	Government Size (%)
National	8622	2.90	19.70
Mean	9377	2.97	17.48
S.D.	7166	0.79	12.53
C.V.	0.76	0.27	0.72
	2004		
National	10561	3.21	20.81
Mean	14079	3.34	17.28
S.D.	10650	0.79	10.28
C.V.	0.76	0.24	0.60
	2008		
National	22698	3.32	20.82
Mean	25781	3.36	21.55
S.D.	15358	0.62	15.50
C.V.	0.60	0.18	0.72

*Source:* China Statistical Yearbook in various years.

Institutional economists are good at explaining the institutional determinants of better economic performance (Alston, Eggertsson, and North, 1996; Acemoglu and Robinson, 2012). Douglas North (2005) argues for an institutional matrix of formal and informal rules, and Daniel Elazar (1998) argues for a federal matrix of self- and shared rules. Here, the institutional matrix is metaphorically regarded as the double helical structure of corporate entities deduced from the two-factor solution above. Corporate entities within the double helical structure are hypothesized to be self-organized in accordance with the congruence theory of goods and providers. To put it differently, the double helical structure of corporate actions refers to polycentric governance. Does polycentric governance lead to better economic performance? A canonical correlation analysis is employed to explore the correspondence between polycentric governance and economic performance, and the canonical loadings are summarized in Table 6. Economic performance is represented by economic wealth, distributive justice, and government size, and polycentric governance is represented by the market governance of enterprises, the social of NPOs and associations and the state governance of governments and communities. The results of the canonical correlation analysis show that the market governance of enterprises resulted in the better economic performance of large economic wealth, low income gap between urban and rural, and small government size through time. The better performance of market governance seems to confirm that market economy holds the unity of efficiency and equity, for the larger pie made by market efficiency is precondition for the equitable distribution of the pie.

Moreover, the results of the canonical correlation analysis show the social governance of NPOs and associations related to small government size, and the role of the state governance of governments and communities did not reconcile economic growth and distributive justice through big government until 2008. Empirical studies show that civil society organizations have entered almost all the fields of public services previously provided by the monopoly of governments (Salamon, 1995; Salamon and Anheier, 1996), which means to some extent the substitution of civil society organizations for governments in the provision of public services that can reduce the size of government. Some scholars would say that markets deal with economic wealth, and governments do with distributive justice (Samuleson and Nordhaus, 2010). Other scholars would argue that governments are conducive to economic growth, but empirical studies show that there is an optimal size of government (Bergh and Henrekson, 2010). To sum up, the role of government is limited for economic development in terms of economic growth and distributive justice.

Table 6. Canonical Loadings Matrix

		2001		2004		2008	
		CVs1	CVs2	CVs1	CVs2	CVs1	CVs2
Economic performance	Economic Wealth	0.85	0.49	-0.84	-0.51	0.77	-0.57

	Distributive Justice	-0.85	0.29	0.79	-0.11	-0.76	0.33
	Government Size	-0.68	0.73	0.68	-0.71	-0.84	-0.53
Polycentric governance	MEO Governance	-1.0	-0.10	0.99	0.11	-0.98	0.21
	CSO, DSO Governance	0.10	-1.0	-0.11	0.99	0.21	0.98
Canonical correlation		0.93	0.56	0.93	0.70	0.95	0.81

Note: CVs denote a pair of canonical variates.

Source: Census data from the National Bureau of Statistics of China and *China Statistical Yearbook* in various years.

Polycentric governance connotes not only autonomous governance of political state, market economy, and civil society but also collaborative governance thereof. Comparative institutional analysis argues that a system of formal rules works more productively if it is embedded in the system of informal rules (Aoki, 2001). Concretely, social capital in terms of trust networks is derived from civil society and conducive to economic growth driven by market efficiency (Grootaert and Bastelaer, 2002). The faster average annual growth rates of enterprises and associations in transitional China to some extent confirm the institutional co-evolution of market economy and civil society. In addition, the significant correlation between the social governance and small government size suggests that civil society organizations play a complementary role in the provision of public services in light of the partnership theory of government and NPOs (Salamon, 1995). Government takes responsibility for financing public services, but has NPOs produce them, which is assumed to save bureaucratic costs, not to mention the equity issue for charitable organizations can deliver public services to the disadvantaged effectively. The polycentric pattern of corporate actions does imply institutional arrangements of multilevel governance in terms of a compound republic (Ostrom, 2008). Empirical studies show a federal system of governance with a Chinese style is conducive to economic growth (Qian and Weigast, 1996; Lin and Liu, 2000).

## 5. Conclusion

China has been in transition from a totalitarian regime towards a market economy, a civil society, and a political state for economic development in the context of globalization. The constitutional framework of polycentric governance with a double-loop learning system of institutional change is built up in this article to explain how China has been restructuring its governance systems for better economic performance. The polycentric pattern of governance may be metaphorically understood as the trivariate normal distribution of corporate entities across the state, the economy, and the society. Polycentric governance in terms of the unity and

diversity of corporate entities corresponds to the constitutional trinity of the state, the economy, and the society as three corporate persons. Based on the principal-agent theory of property rights, the separation and combination of the three corporate persons above can account for the formation of the polycentric governance of corporate actions.

The findings of this study signify that the Chinese market economy with the better performance is embedded in the state and society in terms of the corporatization of collective actions. Just as Robert Putnam (1994) argues that the stronger the society, the stronger the economy and the stronger the state, Chinese scholars should take civil society seriously given a paradigm shift from the old mixed economy of government and market to the new mixed economy of government, market, and civil society. Expanding the scope of corporatization is the strategic choice for China in transition from a totalitarian regime, for the Chinese people have asked for the rule of law and democracy in terms of self-governance. To conclude, China's better economic performance attributes to its polycentric governance of corporate entities.

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