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Institutional Change and Economic Development: The private sector in China and Vietnam

Abstract: China and Vietnam have achieved tremendous economic growth in the past decades. The successful development despite their weak formal institutions has deeply challenged conventional economic theories and has demonstrated an undervaluation of informal institutions. In this study, the emerging private sector that has vastly contributed to the rise of China and Vietnam is analyzed based on theories within the study fields of *New Institutional Economics* and *Economic Sociology*.

Key words: new institutional economics, economic sociology, private sector, informal institutions

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1. Introduction

The rise of China's economy has astonished the international community. It has become one of the most controversially discussed and researched topics, making world-famous economists and Nobel-prize winners questioning commonly accepted fundamental principles of economic development. Additionally, the world is as well keeping a close eye on other rapidly developing countries, inter alia, Vietnam, who has often been referred to as China's little brother, seemingly following a similar development strategy with considerable success. While OECD countries such as the U.S., many European countries, and Japan have entered a period of economic difficulties, coping with major issues such as rising youth unemployment, growing wealth gap and other issues, the two Asian countries were among the few rising economies, showing average GDP growth rates of 10.9 percent in China and 7.06 percent in Vietnam between 2005 and 2010 (CSY, 2011). Other accomplishments were the reduction of poverty, and gaining importance within the international market. Particularly China has been attributed to stabilize the global market.

The research problem deals with the importance of the emerging private sector in China and Vietnam whose development and success cannot be fully explained by conventional theories of *New Institutional Economics* (NIE). The purpose of this paper is therefore to analyze the private sector development of China and Vietnam by utilizing a theoretical framework that is based on *New Institutional Economics* but extended by subfields of *Economic Sociology*. In this sense, there is an empirical research question as well as a theoretical research question that are closely intertwined.

- 1.) How did the private sector in China and Vietnam grow despite the institutional weaknesses?
- 2.) To what extent can the study fields of *New Institutional Economics* and *Economic Sociology* explain the private sector development?

The methodology used to answer those research questions consist mainly of literature-based research, while an own case study has been added. Analyses and comparison based on quantitative methods or official statistics are avoided due to the unreliability of data concerning this specific subject. However, the chosen methodology contains weaknesses and limitations. For instance, the country-specific literature and research makes generalizations extremely difficult. Also, theories that are formulated based on the findings are rather vague and cannot be supported by empirical evidence. Furthermore, a fraction of the previous

research as well as the case study are based on subjective survey data, which is typically associated with a variety of difficulties. For instance, the subjective perception does not always reflect reality. Moreover, truthful answers are not guaranteed, either because of misunderstanding or lack of willingness to provide them. Therefore, all the results and findings will be carefully and cautiously interpreted, while keeping these limitations in mind.

The paper is divided into three main sections. At first, an introduction into the study field of New Institutional Economics is given, describing, analyzing, and contrasting the most prominent representatives and their perspectives. NIE is still considered to be in an infant stage, plus informal institutions have typically only been briefly mentioned. This indicates that it plays a marginal role. Hence, another field of studies will be introduced, namely *Economic Sociology*. The rationality behind this is that informal institutions such as informal networking, norms and behaviour, are in essence a part of social science, which many economists have failed to incorporate in their models. Following the theoretical framework, an overview of China and Vietnam is given regarding their initial conditions, development strategies, the role of the state, and important policies. These factors will give an overview about the formal institutions that influence economic activities and will as well underline the limits of NIE. Therefore, one particular sector is picked out to exemplify the power of informal institutions, namely the private sector. A detailed analysis of this sector will provide a greater understanding of informal institutions and therefore help to further expand the field of NIE, suggesting the incorporation of social science subfields such as Economic sociology and recommend models, theories, and policy recommendation based on cross-disciplinary studies. This paper is in essence a literature based study that has been extended by a small, self-conducted survey.

2. Theoretical framework

2.1. New Institutional Economics

The late 70s marked the revival of *Institutionalism*, modified by including game-theoretic approaches, referred to as *New Institutional Economics*. New Institutional Economics is a fairly recent and still evolving field of study. It is an umbrella term for economists that emphasize the importance of institutions in determining an economy's success or failure (North, 1994, Williamson, 2000, Angeles, 2011). Various difficulties arise with this subject. Variation and disagreement exist among authors regarding the definition of institutions, the nature of institutions, meaning how they develop, persist, and change, as well as about the

relationship between institutions and economic development. In the following, the perspective of prominent institutional economists is presented, while contrasting their emphasis on different aspects. According to North (1990, p.3-4) institutions are humanly devised constraints that shape human interactions, thus providing incentive structure. They can be of formal or informal nature, as well as be created or evolving and the main purpose is to reduce uncertainty. This is a commonly shared perspective. Harris, Hunter, and Lewis (1995, p. 25) highlight the interdependent nature of formal and informal rules, and state that the mixture of those two as well as the enforcement ultimately determine economic performance. Despite many disagreements about specific aspects of institutions, it has been regarded as a highly significant study field. The hope is that it will facilitate developing alternative policy recommendations that are based on a more realistic view of economic development than the prevailing neo-classical theory (Harris, Hunter, Lewis, 199, p. 3, 7).

Development, change, and stability of institutions

When it comes to the questions how institutions are developed and established, there are two extreme viewpoints suggested by Hardin (1982: 2). One perspective regards institutions as the result of deliberate action, typically induced by the government, also called *top-down approach*. This would include policies, laws, and reforms introduced by a higher authority such as the state. In this case, formal rules are introduced and enforced by a third party, meaning that institutional change occurs quite rapidly (North 1990: 6). This view puts a higher authority such as the state and lower government bodies into the centre of interest since they are the main decision-makers. In contrast, institutions can also be considered as an evolutionary process, developing rather spontaneously, corresponding to the changing informal rules among individuals. In this case, there is no formal agreement about the ongoing rules, but they are commonly accepted since they reflect people's own values. Additionally, these slowly developing institutions are attributed to be self-enforcing and thus more stable since their effectiveness is based on game-theoretic concepts. Instead of the state, individual economic actors and organizations are in focus, meaning that private entrepreneurs and informal business networks are the key drivers. In Hayek (1973, p.5) has named these two extreme views *made order* and *evolutionary rationalism*. North (1990, p.6) adds that institutions usually evolve incrementally.

The evolutionary nature of institutions has been found to be considerably effective despite the lack of an independent third party and clearly-cut out rules. The reason for this is that those institutions have become self-enforcing by being internalized in people's mind. Their

behaviour is therefore guided by commonly accepted informal mechanism within their community such as social sanctions in case of rule violation (Furubotn, Richter 2011, p. 288).

Based on this theory, the agent of change in the economic sense is therefore the individual entrepreneurs, interacting within an institutional framework, while at the same time exerting influencing on existing institutions, possibly leading to change and alteration in the long-run (North 1990, p. 83). Neither the top-down approach nor the bottom-up development of institutions are an easy process, both carry its own difficulties. At first sight, the top-down induced institutions appear more straightforward and uncomplicated since the institution is directly created and technically effective immediately.

Besides the issue with this new institution being accepted by the broad masses and internalized in their behaviour, one major problem for the authority, often the state, is the introduction of the *right* institution at the *right time* (Chang, Rowthorn 1995, p.39). Many international organizations such as the *World Bank* (WB) and the *International Monetary Fund* (IMF) have based their policy recommendations on neo-classical theories that advocate the idea of free market mechanism with as little state intervention as possible. The rise of economies under authoritarian regimes, combined with the rather disappointing development of newly democratic countries has shed a new light on the significance of state involvement, showing that economists will have to take into account the complex role of the government (Nolan 1995, p.239)

Timing and the *right* institutions

A vast number of prominent institutional economists have emphasized the significance of effective property rights in inducing growth. According to North (1990, p.81), competition, decentralized decision-making, effective property rights, and bankruptcy laws belong to the most important institutions since they not only encourage and reward high performance and successful efforts, but also suspend unsuccessful efforts. Particularly, the role of well-specified property rights has been underlined by a variety of academics (Angeles 2011). Despite the strong focus on formal institutions, informal institutions have been commonly acknowledged as playing an important role as well. The theory of mental models argues that idea and ideologies are crucial since they determine the way individuals interpret their institutional environment (North 1990, p.111, Harris, Hunter, Lewis 1995, p. 25). For instance, the government may introduce a new law, but if society generally has absolutely no

trust in the enforcement of laws, they will make their economic choices as if the law does not exist, making the government's effort completely ineffective.

This aspect is of particular importance in developing and transition economies where general mistrust in laws persist among people, making most top-down decisions regarding institutional change unsuccessful. This realization suggests that institutional change must begin within people's mind. When discussing about the most important institutions, disagreement also exists about whether formal and informal institutions should be regarded as complementary. According to Williamson (1996), informal institutions may play a major role in developing and transition economies, but as the process of economic development becomes more sophisticated and complex, more effective formal institutions will be established, making the formerly necessary informal institutions redundant. The opposite view would be that the importance of informal institutions will not diminish with the introduction of effective formal institutions (Johnson, McMillan, Woodruff 2002).

Summary

In summary, NIE theories offer a valuable basis in understanding the role of institutions in shaping economic outcomes. In essence, institutions are considered to be the key determinant of an economy's development. Main issues derive from the theoretical inconsistency among institutional economists as well as the difficulty in conducting empirical research (Harris, Hunter, Lewis 1995, p.7). Nonetheless, NIE aids in gaining insights into a major source of economic growth. Effective property rights, rule of law, and other market-supporting institutions certainly play an important function by reducing uncertainty within business environments. Although these formal institutions are of high significance, especially for the long-term economic performance, they are extremely difficult to establish in a transition economy and accepted among the ruling political party members, not to mention among society. However, the dominant literature has vastly neglected the importance of informal institutions, a significant part that requires more detailed research. This may lead to inadequate policy recommendations since informal institutions play a significant role in shaping economic behaviour, particularly in developing and transitioning economies. For this reason, another field of studies will be introduced that will help understanding the mechanism of informal institutions.

2.2. Economic sociology

Economic Sociology deals with the sociological perspective applied to economic occurrences. This includes personal relations, group formation, social control mechanisms, and most recently, the study of social networks under consideration of the cultural environment (Smelser, Swedberg 2005, p.3). Many attempts have been made to incorporate the subject of social relations into the study of economic behavior (Smelser, Swedberg 2005, p.49). Bounded rationality is an important concept within economics, but orthodox economists habitually neglect the influence of culture and norms on an individuals' decision-making, a mistake that can be solve by following a sociological approach.

In the following, three essential components will be introduced, utilizing elements of economic sociology to explain growth-enhancing economic phenomenon in virtually complete absence of formal institutions. These components are highly intertwined and are regarded as potential key drivers of an economy. The first factor is the private entrepreneur as an individual agent and social actor who has the potential to exert enormous influence on the institutional framework of the economic sphere. The second main aspect deals with social networking as a tool to combine and extent the power of those entrepreneurs, enabling business transactions with minimum risks. Finally, localized industrial cluster that can result from organized networking activities and may significantly contributed to economic growth are examined in terms of development, significance, and limitations. Informal institutions serve as a viable substitute to formal institutions in dealing with common problems that entrepreneurs face in an uncertain business environment. The subfields in focus will form a framework that serves as an analytic tool to understand the private sector in China and Vietnam.

General

Social embeddedness is a crucial constituent that has been specifically accentuated by Granovetter, referring to the high influence of existing social relations on rationally acting individuals. The focus lies on informal solutions in dealing with trust issues within a business environment (Nee 2005, p.53). This approach seems more appealing in explaining business practices in transition economies that are typically characterized by flawed legal system, thus increasing the significance of informal mechanisms.

Entrepreneurship

The role of entrepreneurship will be one of the key aspects of this study paper. Since the mid-20th entrepreneurship has gained the attention of economists' community, triggered by the work of Schumpeter in 1934 who has defined entrepreneurs as a key driver of economic growth (Vuong, Tran 2009). Important to note is that the role of entrepreneurs have to be examined in the country-specific cases, meaning that the institutional environment has to be taken into account. In order to later inspect the function, power, and limitations of entrepreneurs in China and Vietnam, entrepreneurship has to be studied within a particular economic, political, and cultural environment. This environment is characterized by enormous obstacles for private entrepreneurs, especially in pre-reform period. Due to the socialist heritage, private businessmen have struggled with negative associations, since they represented bourgeois values and capitalism, exactly contradicting to the communist ideas that dominated the countries at that time. For this reason, private entrepreneurial activities were mostly conducted semi-illegally and took place within the informal sector, meaning that hardly any accurate data sets exist about these movements.

Generally, entrepreneurship is a valuable source of economic growth, providing dynamism and competition, innovation, new technology, creating business opportunities, and employment opportunities, regardless of the country's development stage (Lu 1994, p.3, Aldrich, Ruef 2006, p.460). One of the most interesting aspects about entrepreneurship is that they can either reproduce or challenge existing orders (Aldrich, Ruef 2006, p.451). Starting a business is always associated with risk, which is even accelerated in a suppressed market that exists in most socialist authoritarian regimes. Due to the fact that entrepreneurs face serious obstacles in terms of socio-political legitimacy they have to find ways of operating within a hostile system. Eventually, their efforts can affect their surrounding environment and possibly alter the polity and cultural norms in their favor (Aldrich, Ruef 2006, p.468).

Even when authoritarian leaders take the decision to follow a pro-market approach by legitimizing private entrepreneurial activities, the transition towards a sophisticated market is a lengthy process, leaving entrepreneurs in transition periods with a highly unstable environment filled with uncertainty. In order to survive, private entrepreneurs must therefore become creative in dealing with every-day business issues. But the importance of entrepreneurs in former-socialist countries goes beyond transforming the economic sphere. Entrepreneurial activities have been attributed to indirectly pioneer political reforms (Lu 1994, p. 53). This viewpoint can be easily understood if the top-down and bottom-up approach are regarded as mutually influencing forces. Assuming that the state is a benevolent

leader, successful entrepreneurial activities that contribute to the overall economy will eventually be legitimized and promoted, even if the activities oppose the ruling party's ideology. Researchers have found reforms regarding the private sector to be the result of interaction between pragmatic leaders within the ruling party and private innovative activities (Lu 1994, p.107). The growing number of journal articles and conference about entrepreneurship and the rapid growth of business schools in the 1990s suggest that it has reached a phase in which it has been conceptualized as an academic field (Aldrich, Ruef 2006, p.470).

Social networking

Social networking is a valuable practice because linking individual together in an informal network or affiliation provides a form of social order. Simultaneously, this order gives an incentive structure, including new opportunities and constraints that are commonly accepted by the actors (Smith-Doerr 2005, p.377). Trust is a key factor when dealing with business partners, especially in an institutional environment in which basic rights will not be protected by formal laws. Furthermore, trust is more easily established between people who are similar or alike. This gives an explanation why business networks based on trust are easier to establish in homogenous countries since people instinctively bond better with other of their own ethnicity (Aldrich, Ruef 2006, p.459). Following this logic, countries with a heterogeneous population, for instance Malaysia and Indonesia with a large number of ethnic Chinese will struggle to develop inter-ethnic business networks. The leaders of those countries must therefore firstly ensure a harmonious relationship between different ethnic groups.

The concept of *Guanxi* or *Giao Luu* is not unique to China and Vietnam. Establishing and maintaining personal connections with the purpose of benefiting your future business is common practice in all countries, including highly developed economies. Nonetheless, the extent to which it influences the business performance differs. Other than serving as an alternative to relying on formal institutions, the power of personal networking is also accelerated due to the respective culture. One of the most interesting aspects in social networking is that close-knit relationship between businessmen can substitute for the lack of effective laws and regulations to a certain extent. The court system is thus replaced by social mechanisms that can be divided into rewarding mechanism such as high reputation and status among the business community, and sanctioning mechanisms such as gossip (Granovetter 1985). These mechanisms are particularly powerful when the business community is

localized, meaning that it is easy to acquire information about other members and when finding a new business partner is rather difficult. In this case, the success of a firm highly depends on its reputation that is ultimately determined by fellow businessmen and customers. As a consequence, fair cooperation is in the interest of rationally acting individuals and thus crucial for success.

Regional clusters

Organized social networks can take form of a very particular type, namely regional clusters. This phenomenon has caught the attention of economists since the emergence of famous and highly successful regional districts such as Silicon Valley in California (Furubotn, Richter 2011, p. 309). Porter (1998, p.273) argues that industrial clusters are the origins of an economy's competitive advantage. Cluster theory is integrated into the overall theoretical framework since it forms the basis of the private sector growth in China and Vietnam. One of the most prominent researches regarding regional cluster has been conducted on Silicon Valley, the prime example for a successful cluster. According to Saxenian (1994, p. 166), the strength in industrial districts lies in the opportunity for collective learning, information, resource, and technology sharing between specialists through informal communication channels which significantly quickens the process. Furthermore, the density of the network of like-minded people creates an atmosphere that encourages mutual collaboration, ultimately leading to innovative activities (Smith-Doerr, Powell 2005, p. 387).

The close geographical and spatial proximity therefore brings many advantages. It allows specialization on a certain products or service. Industrial clusters are therefore regarded as self-enforcing institutions. A company's success highly depends on the achievements' of other firms since they share many resources and their products often complement each other. Moreover, they typically hold ongoing business relations, meaning that the repetitive contracting most likely leads to social relationships that promote reciprocating behaviour. In summary, due to the spatial proximity, governance is carried out based on general trust which makes the system reasonably stable. Otsuka and Sonobe (n.a.) have studied industrial clusters in East Asia and developed an endogenous model of cluster-based industrial development that distinguishes between three phases: the initiation phase, the quantity expansion phase through imitation activities, and finally the quality improvement phase through innovation and technology upgrading. The last phase is the most problematic one since there are contradictory theories and cases regarding the way to achieve it. This typically splits the academic community in opposing sides. On the one side there are advocates of technological

leapfrogging through integration into a global value chain and moving up the technological ladder through foreign direct investment (FDI) and joint ventures. On the other side, the development of strong domestic capacities is highly emphasized through investment into R&D and education, meaning that the dependency on foreign countries is reduced.

Concluding remarks

Ideally, the formal and informal rules of the game are aligned in a manner that there is no conflict of interests. However, this ideal case is quite rare. Especially in a country that is undergoing a major transformation, the speed of change differs significantly. For this reason, formal rules laid out by the government are often inconsistent with the informal rules that in reality guide the behaviour of important actors. This misalignment will most likely lead to noncompliance or oppositional behaviour on the side of economic actors. This can take form of discretely circumventing the official rules up until actively resisting against them, also referred to as *decoupling* from norms (Nee 2005, p.59). As soon as the process of decoupling starts and gains power through rising number of participation, the reaction of the government is extremely important for the subsequent development path, most likely determining economic success or failure in the long-run.

3. Institutional Analysis of China and Vietnam

China and Vietnam have been chosen as the countries in focus for various reasons. First of all, they share many similarities in terms of history, culture, and development path. Both countries have a rather homogenous population, they have been traditionally influenced by socialist ideas and are still dominated by a communist party with virtually no political competition existing (King, Szelény 2005). Moreover, they have undergone devastating periods that have left the country economically stagnated and the people poor. The Great Leap Forward and Cultural Revolution in China, and the Vietnam War have tremendously traumatized the country. Furthermore, they have started with similar factor endowments. Although the countries heavily differ in size, at the beginning of reform both had a large surplus of cheap and unskilled labour. Also, there is common agreement that China and Vietnam have exceptional social indicators in terms of health and education in pre-reform period compared to other low-income countries (Harvie, Tran 1997, p. 16). In addition, the government has introduced a similar development strategy. They have started with modernizing the agricultural sector since the majority of the population worked in rural areas. Since the state has decided to address and reform a sector that affects a large part of the population they gained trustworthiness of the masses which strengthens their legitimacy. An important component of the state's strategy is the gradual and incremental approach, initiating reforms step-wise and on an experimental basis. High economic growth and poverty reduction also went along with relatively equal distribution of wealth, indicated by a GINI coefficient of 35.6 in Vietnam and 42.6 in China in the year 2008 (The World Bank 2014). Despite these similarities, Vietnam's growth has been significantly below China's (Vu 2009). An institutional analysis might provide a reason for this divergence.

The second reason for choosing China and Vietnam is the fact that their cases strongly contradicts with conventional theory about the main determinants of economic growth. The theory of NIE is that institutions are crucial to a country's development, while the literature mainly studies and emphasizes the importance of formal institutions such as property rights and the rule of law. An analysis of the economic growth in China and Vietnam will illustrate that although core principles of NIE are indeed valid, but this field of studies has vastly underestimated the importance of informal institutions. For this reason, subfields of *Economic Sociology* will be examined to gain a deeper understanding of the nature and mechanism of informal institutions and their interaction with economic development. This will help in formulating more efficient policy recommendation for developing countries that severely lack

formal institutions. To begin with, the formal institutions that have been emphasized by NIE are analyzed, consisting of the political and legal framework.

3.1. Formal Institutions

This sections deals with the formal institutions that have a strong influence on private firms. Key elements are the political and legal system. In China and Vietnam, the problematic aspect is that the *de jure* rules and *de facto* rules typically diverge to a large extent. For this reason, one must analyze policies, laws, and regulations with careful consideration.

The Communist Party

An analysis of economic phenomenon in China and Vietnam cannot be fully made unless the political sphere has been examined as well. Characterizing their form of government as a one-party system ruled by communist leaders in an authoritarian style would be an oversimplification of the real politics. First of all, it is in fact a one-party system, meaning that that the communist party will technically remain in power indefinitely. Although party members were traditionally explicitly chosen based on their ideological conviction, this does not mean that the majority still holds on to the original communist ideas. On the contrary, the ideas within the parties have become more progressive for different reason.

One decisive step in China was made by Deng Xiaoping who pushed for economic reforms that essentially stand in contrast with communist ideologies, leading the way for a more pragmatic approach towards leading the country. Furthermore, although political reforms were less visible, they in fact existed and are still advancing. For instance, the newly introduced seniority system and the introduction of merit-based entrance exams for bureaucrats brought many young professionals into powerful government positions that were better educated as well as more open to progressive ideas (Li 1998). This has led to a form of inner-party democracy, with conservative and progressive members constantly balancing each other out, which allow reforms with capitalistic tendencies despite the socialist legacies.

According to Vuving (2006), the communist party in Vietnam is divided into two fractions of modernizers and traditionalists, essentially similar to the Chinese party. Regarding a direct comparison, several authors have argued that the Central Committee is more democratic as well as more powerful than its counterpart in China which they traced back to a high number of members with diverse backgrounds (Thayer 2009). China and Vietnam have undergone a tremendous transformation towards a market economy, while preserving socialism as the core character (Harvie, Tran 1997, p. 164). Although the ruling political party maintains

tremendous power over economic activities, political decentralization has taken place. In China, this decentralization system has led to a type of federalist system, in which central government's influence is reduced and competition between local governments is encouraged (Montinola, Qian, Weingast 1995). These decentralization processes have been attributed to lay a political basis for economic growth. In Vietnam, decentralization has predominantly occurred in form of delegation of administrative tasks whereby the degree heavily varies across the country. However, the relatively low educational level of local officials represents constraints to the effectiveness of decentralization (Fforde 2003).

Development strategy

In the initial phase, the first issue to be dealt with was agriculture since the current system at that time was highly unproductive and the vast majority of the population lived in rural areas. Then the focus shifted towards the industrial sector, aiming at expanding autonomy at firm-level. Despite these similarities, major disparities led to slightly different situations. For instance, China entered the reform period with a more advantageous starting point in terms of macroeconomic conditions. Vietnam was listed as one of the poorest countries in the world and dealt with declining growth, hyperinflation, large budget deficits, and high dependence on foreign savings, food shortages, and deteriorating external circumstance. China had a low inflation and budget deficits, high savings, and low external debts, plus the industry was stronger than in Vietnam, where agriculture was the largest sector (Harvie, Tran 1997, p.192), Vu 2009).

A general common feature the development strategy of China and Vietnam that distinguishes them from other transition economies, for instance Central Eastern European countries, is the devotion to gradualism. Whereas many former Soviet countries followed the policy recommendations of the World Bank and IMF and pursued a big bang approach characterized by rapid privatization and a focus on macroeconomic reforms, the leaders of China and Vietnam took a different path. Experts agree that it was exactly this incremental and experimental leadership style that was decisive for the subsequent emergence of an efficient market system.

The government set out guidelines and objectives without specifying the exact steps to undertake, allowing economic actors to choose and influence institutions based on trial and error. As a consequence, bottom-up movements could evolve (Tran, Le, Nguyen 2008, Nee and Oppen 2012, p.9), consisting of realignments of the different interests between the various

economic actors. Naturally, this led to a more market-driven economy. Another advantage was that formal institutions tend to follow ex post changes in the informal business sector, meaning that they were compliant to the needs of businessmen (Nee 2005, p. 61). Vietnam's reform period can be divided into two phases: The early period of reforms between 1986 and 1989, and the transition to market economy between 1989 until the present (Harvie, Tran 1997, p.48). In 1986, the Sixth national Congress defined liberalization and deregulation of the economy as the main goal, marking the start of a new era. Compared to decollectivization process in China, Vietnamese reforms appear more conservative, indicated by shorter land leases and limits on hectares per household (Karadjis 2005).

Socialist countries such as China and Vietnam could only have succeeded economically under the condition that capitalistic measurement became accepted. King and Szelényi (2005, p.206) distinguish between three ways in which capitalism emerges within a communist system. The case of China and Vietnam is categorized as capitalism from below and, characterized by the bottom-up development of a private and hybrid sector, which the government has not directly anticipated. Moreover, the new market system relies strongly on domestic firms co-existing with large and powerful state-owned companies, whereby the manufacturing industry is the leading sector. Regarding the political structure, the former totalitarian regime has been partially liberalized, while patron-client relations are common practice (King and Szelényi 2005, p.213). Capitalistic structures can therefore be regarded as an unintended by product that is necessary for the growth of the private sector.

Market-supporting formal institutions

An analysis of the political system in China and Vietnam reveals a difficult environment for private firms. Although reformist ideas have tremendously gained popularity, resistance within the party is still apparent. In order to demonstrate more clearly the hostile environment private entrepreneurs have to face in those countries indexes of international organizations are utilized. One suitable measurement of overall formal institutions is the *Economic Freedom Index*. It comprises various factors, property rights, corruption, and business freedom to examine four larger categories within a country: rule of law, limited government, regulatory efficiency, and open markets. A high index is associated with greater prosperity (The Heritage Foundation 2014).

In general, China and Vietnam score relatively low. China's score of 52.2 and the results for Vietnam of 50.8 are below world average and the countries are therefore classified as *mostly*

unfree. Breaking down this score into its individual indicators, one can see that the main issues for both countries lies in investment freedom, financial freedom, property rights, and freedom from corruption, mostly the determinants of *rule of law*. Property rights that have been repeatedly singled out as a crucial formal institutions for growth by NIE is in fact the most troublesome factor with a score of 15 in Vietnam and 20 in China out of 100. In a world-wide comparison of 178 countries, China therefore ranks as 137 and Vietnam as 147.

These governance weaknesses are also reflected by the Provincial Competitiveness Index (PCI) that measures the willingness and capacity of the provincial government to create a market-friendly environment for the private sector. Transparency is a key factor, ranging from information availability to active participation of private firms in policy decision making. Vietnam has been classified as a Level 1-country, meaning that it scores very low on the transparency scale and that there is a lack of dialogue between firms and government (The Asia Foundation 2011). According to conventional NIE theories, these weaknesses in formal institutions imply that the economy in China and Vietnam must be highly underdeveloped as well, but the opposite is the case.

3.2. Private sector development

The emergence of the private sector in China and Vietnam is chosen as the analytical focus because it perfectly illustrates the underestimated significance of informal institutions. In addition, it is the sector with the highest growth rate and entrepreneurs are considered to hold a pioneering position within society, highly influencing the reform process (Heberer 2003, p.3). Furthermore, the institutional environment is in a phase of rapid and dramatic change that is guided by the government as well as by bottom-up developments. Therefore it exemplifies an economic potential that can be unfolded by a favourable interplay between informal and formal institutions.

The analysis of private sector development (PSD) is divided into four main sections. First of all, a general overview about the private firms in pre and post-reform China and Vietnam is given, comprising of the institutional environment, particularly the role of the government in influencing this sector. Secondly, the analysis takes a more in-depth and micro-level perspective by examining the Chinese and Vietnamese entrepreneur as the main actor within the institutional environment, taking into consideration the cultural and socioeconomic context. An essential component hereby is the utilization of informal institutions such as social networks to cope with business risks. After that, the economic phenomenon of regional

clusters is explained by giving concrete examples. Finally, a summary and cross-country comparison is provided, as well as backward linkage to the theoretical framework.

3.2.1. Overview

First of all, when analyzing the privatization strategy of China and Vietnam, the first step is to recognize that their policies gradually allowed the entrance of private firms. This stands in contrast with the tactic of privatizing the existing enterprises which was wide-spread among Central and Eastern European countries (van Arkadie 1995, p.276). In China and Vietnam, the initial trigger for bottom-up privatization development was wide-spread poverty in the country side (Heberer 2003, p.11). Complying with government set-out rules presented no prospect, increasing the incentive to decouple from these rules. Instead, a return to small family businesses was observable with the anticipation of better living standards. This practice became easier in areas where local governments tolerated those illegal activities, either out of self-interests or because they simply had no means to effectively stop them.

Regarding the general political environment, the ruling party is dominated by communist ideology and will most likely stay in power. At the same time, the private sector has developed to become a powerful engine that vastly contributed to the economy's wealth and has achieved a high-regarded status, both among the political leaders and the society. In the following, the various factors will be examined that have led to the strong growth of private businesses despite the lack of supporting institutions. Overstatement of the importance of formal institutions is common, backed up by the rapidly expanding number of private business after the introduction of economic reforms. Still, these numbers can be misleading. Several firm-level empirical studies have found extensive private business activities, mostly in the informal sector that could not be captured by official data. Based on these findings, the conclusion is made that informal institutions must play whereby the specific mechanisms need to be studied in more detail.

China

In China, the rapid development of a strong private sector was not anticipated by the government. In later reform phases, the state started to actively facilitate and promote private sector growth, but initially private businessmen operated in a semi-legal zone with basically no market-supporting institutions. In the 1980s, private firms were typically either registered as collectives or operating in the informal sector. The origins of many private firms in rural areas can be therefore be traced back to *township and village enterprises* (TVE), a

collectively-owned company that is run by the local government and managed collaboratively. Despite the emergence of different forms of TVEs, they all shared certain common characteristics. For instance, they were led by private entrepreneurs, but strongly intertwined with the local government and their ownership form was vaguely defined (Xu, Zhang 2009).

During the initial transition phase that was characterized by high uncertainty and constant changing environment, these firms flourished due to their intrinsic nature. Being a hybrid form between private firms and state-owned firms, they featured characteristics that enabled them to take advantage of the transition phase. These hybrid firms were considered the source of prosperity for local governments in the 1980s (Nolan 1995, p. 248). Not only did these firms absorb the large labour surplus after the agricultural reforms, but they were a valuable source of income for the local government, making officials directly interested in their high performance.

Starting in the mid-1990s, the success of TVEs negatively correlated with the rise and recognition of private ownership. Still, many private firms were spin-offs from TVEs and they are still considered to have been the backbone of the emerging private sector. The existence of TVEs is a unique Chinese phenomenon that considerably contributed to a smooth transition. Riedel and Comer (1995) even argued that the reason why long-term growth in Vietnam is less remarkable compared to China because an equivalent hybrid form in Vietnam never existed (Harvie, Tran 1997).

One of the most decisive periods for the private sector was the mid 1990s when a new Company Law was introduced and China was officially acknowledged to be a *socialist market economy*. Since then, establishment of private companies have skyrocketed with a growth rate of 35 percent on average (ten Brink 2012). According to Nee and Lian (1994) one influential factor was the declining commitment to communist ideology (Smelser, Swedberg 2005, p.61). As economic development became key priority of the government, ideology receded into the background. Still, even after the emergence of real private firms, the official policies treated them as an inferior company type to SOEs in the beginning (Lu 1994, p.123). This lack of acknowledgement did not prevent the private sector from growing. By the end of the 1980s, the private sector in Wenzhou accounted for at least 40 percent of GMP. The local economy was estimated to be coordinated to 80 percent by the free market. This resulted in rapidly rising standard of living. In 1989, the per capita money income of urban residents in

Wenzhou was 33.25 percent higher than the national averages, turning one of the poorest areas to a role model for economic prosperity (Lu 1995, p.126).

In retrospect, private entrepreneurs can be attributed to be the pioneers of China's economic reforms. In the 80s, the development process was characterized by reformist leaders and private entrepreneurs simultaneously urging for institutional change that would facilitate growth. Although at the beginning, the small-scale business activities within the private sector were condemned by the government, approval grew with their success rates. In the end, the government realized the potential and pragmatically responded with market-supporting institutional adjustments (Lu 1995, p.126). The political perception of private sector went from antagonistic to supplementary until it was officially referred to as an important constituent of the economy in 1999 (Heberer 2003, p.19).

Vietnam

According to a study in Northern Vietnam, spontaneous privatization processes already occurred in the 1960s, long before the economic reforms, mostly consisting of small family businesses that produced basic commodities (Heberer 2003, p.15). According to a study, SMEs accelerate the industrialization process, provide employment and income, and support large enterprises, making it a dynamic and valuable source of economic growth. Still, SMEs are in a disadvantageous position due to their lack of high technological capacities and high-educated workers, and their struggling with business expansion. Similarly to the Chinese case, private entrepreneurs in Vietnam faced a hostile business environment due to the socialist legacy. In 1995, private firms in Vietnam were found to produce only 7.5 percent of the GDP.

The private sector was highly underdeveloped which was problematic since the rapidly growing labour force could not be absorbed by state-owned enterprises (SOEs). The state recognized this problem and implemented various policies in mid 1990s to counteract these issues, consisting of modifying the regulatory framework of private enterprises (Hakkala, Kokko 2005). However, SOE were still regarded as the leading sector that enjoyed a high status among politicians, meaning that they received preferential treatment regarding credit access. In Vietnam, economic liberalization throughout the 1980s did not include the support of the private sector. Only in 1988, an official law was introduced (van Arkadie 1995, p.277). A major breakthrough for private enterprises in Vietnam was the promulgation of the Enterprise Law in 2000 (Tran, Le, Nguyen 2008) which significantly simplified the

establishment of private firms by abandoning administrative difficulties. This led to an immediate extreme increase of registered private firms.

The sheer number of apparently new firms indicates that a high proportion has existed before as unregistered household businesses operating in the informal sector, a suspicion that has been confirmed by studies conducted by the World Bank (Pham 1999). Although 95 percent of the private firms are SMEs, the terms were not officially defined until November 2001, indicating that their importance was recognized at a very late stage. The case of Vietnam is particularly interesting because it contradicts with the assumption that an efficient legal system and property rights are a prerequisite for economic growth. The Vietnamese economy, partially driven by private firms, has flourished in almost complete absence of formal institutions, representing an even more extreme case than China (van Arkadie 1995, p.262). The importance of the private small and medium-sized companies has long been recognized by academics (Tran, Le, Nguyen 2008). They have been found to contribute 39 percent to the GDP in 2006 and 85 percent of the total workforce of enterprises in 2004 (Sakata 2010).

Furthermore, their contribution of the national budget was higher than that of foreign-invested enterprises in 2002, namely 7.4 percent compared to 6 percent (Nguyen 2007, p.305). However, their development path has been undergone in the presence of enormous constraints and challenges. One major issue is the lack of finance. Obtaining bank loans is extremely difficult for private firms. Firstly, they appear unattractive for the banks because of their small size. More importantly, they face discrimination because of their ownership status. SOEs are the less risky choice in giving out loans since they are backed up by the government and will therefore almost never face bankruptcy. Another survey conducted in 1991, covering 923 urban enterprises confirms that a vast number of private urban enterprises have existed long before the introduction of the *doi moi* reform. Approximately 60 percent were established before 1988 (Ronnas, Ramamurthy 2001, p.7). After the introduction of more liberalized reforms in 1986, there was a sudden increase of private entrepreneurial activities by 21 percent (Ronnas, Ramathurthy 2001, p.59).

It was not until the year of 2000 that the importance of small firms and the private sector as a valuable source of employment and income was formally recognized by the government, indicated by several key documents (Ronnas, Ramamurthy 2001, p.2-3). The growing numbers of entrepreneurs does not necessarily imply that they have been supported by the institutional environment. On the contrary, basic necessities for an entrepreneur such as credit access, market information etc. were extremely difficult to acquire. The research showed that

own savings and borrowing from friends and family made up over 95 percent of the invested capital for household and private enterprises, suggesting that the financial market was highly underdeveloped (Ronnas, Ramamurthy 2001, p.7).

Other than capital shortage as a main problem, entrepreneurs face challenges because of the lack of distribution channels and physical infrastructure (Ronnas, Ramamurthy 2001, p.10). Surprisingly, the surveyed small businesses maintain a strongly reluctant attitude towards government support. In Ho-Chi-Minh City, 76 percent declare that they do not wish for any kind of direct government assistance, with “premises” and infrastructure being the exception (Ronnas, Ramamurthy 2001, p.56). This position indicates that business prefer to rely on other measures. The economic reforms have vastly facilitated the establishment and running of private businesses. Nevertheless, private enterprises, especially in the industrial sector, still face many internal and external challenges. Still, the government has only recently begun to actively promote the private sector, meaning that the full potential has not been realized yet (Schaumburg-Müller 2005).

Comparison

Chinese private sector grew at a more rapid speed than Vietnam. Also, private firms in China are more closely linked to the state sector than Vietnamese firms (Heberer 2003, p.282). According to studies conducted by various international organizations such as World Bank, United Nations Development, and the Asian Development Bank, the atmosphere for Vietnamese private firms has been referred to as *grudging rather than supportive*, in contrast to the Chinese case in which the sector has been acknowledged a key role (Karadjis 2005). In both countries, private business activities were carried out small-scale in the informal sector in the beginning, while formal institutions were completely absent. Exclusively relying on official statistics to capture the emergence of private firms does not show the whole picture since no reliable data exists about informal business activities. However, different studies suggest that the bottom-up development of the private sector has taken place long before it was recognized by the state. Only with continuous success that noticeably brought prosperity to the local government and the region, the private sector slowly gained political legitimacy and external support, but the process was long, full of challenges, and still incomplete.

Although official recognition tremendously facilitated private business activities, the institutional environment was still far from ideal. Basic formal institutions such as an efficient property rights and generally a trustworthy legal system are missing whereby China has

achieved a more developed stage compared to Vietnam. Additionally, private entrepreneurs still face severe discrimination regarding access to bank loans that signified the preferential status of SOEs. In order to overcome these obstacles, private entrepreneurs relied on informal institutions that will be further explored in the following sections.

3.2.2. Entrepreneurship in China and Vietnam

In order to understand the economic phenomenon one has to study the social player within the private sector, namely the entrepreneur. Despite the extensive studies about entrepreneurship, few attempts were made to incorporate informal institutions such as the cultural dimension into the models. Vuong and Tran (2009) have studied private entrepreneurship in Vietnam under special consideration of the cultural and socioeconomic environment. As typical for a country highly influenced by socialist ideas, private businesses were deeply discouraged until the early 1990s. Between 1988 and 1991, private entrepreneurs became target of political assault led by conservative within the party (Nee, Oppen 2012). Not only did the government oppose their activities, but also a social stigma is a powerful impediment. Entering the business world was associated with low status within society, no security and future. Only after the positive effects of private enterprises became visible such as employment creation, tolerance, acceptance, and support grew among the society. Social perception often derives from cultural beliefs. For instance, the social ranking called *Si-Nong-Cong-Thuong* is an old saying whose origins can be traced back to the Chinese version of *Shi-Nong-Gong-Shan*, and which is still present in people's mind (Vuong, Tran 2009). In this ranking, merchants and entrepreneurs are traditionally in the lowest ranking. Although nowadays, few people would agree to this negative association, it illustrates how difficult the emergence of private entrepreneurship was, given the cultural and social settings. Keeping in mind the complete absence of formal institutions, the emergence of a relatively strong private sector is therefore an obscurity.

McMillan and Woodruff (2002) have studied entrepreneurial patterns in transition economies, inter alia, in China and Vietnam. An extensive survey highlights the impediments faced by many entrepreneurs. The difficulties start with the establishment of the company, including acquisition of a business license, registration, tax regulations. In Vietnam, the time required to set up a new business has been found to be approximately six months. Furthermore, the costs associated such as payment of official fees amount to 150 percent of per capita GDP.

Additionally to direct impediments posed by the local government, the lack of efficient formal institutions pose an obstacle to the development of private firms. Market institutions in

Vietnam were still found to be insufficient after a decade of reform. For instance, private companies were still heavily discriminated regarding access to bank loans and the court system was inefficient. In a survey conducted between 1995 and 1997, less than 10 percent said that courts could enforce contracts, and also 10 percent stated that they succeeded in accessing credit from banks. Studies have shown that in order to cope with this uncertain environment, private entrepreneurs develop self-help mechanisms to substitute for conventional market-supporting institutions.

Informal institutions

One important instrument is the development of personalized relations to business partners. Due to the weak legal system, trusts in the enforcement of contracts rights were replaced by trust based on long-term trading relations (McMillan, Woodruff 1999). A survey between 1995 and 1997 of 259 non-state firms regarding relational contracting has dealt with the question on what ground this level of trust is based on. A simple and common situation is when a supplier consents to payment after his customer has delivered his products, meaning that he provides his good in advance. His confidence on the honest repayment of his customer is based on the conviction that his customer wishes to maintain a business relationship in the future, giving him an incentive to comply with the informal agreement (McMillan, Woodruff 1999). Various factors increase the probability of this ideal situation. For instance, the more information is gathered through regular inspection and visit, and the longer the duration of the relationship, the higher is the level of trust. Additionally, the incentive to repay debt is especially strong when it is difficult to find an alternative supplier due to high transaction costs. The lack of alternative trading partners seems to be an influential factor. A company in close proximity of competitors have been found to grant 15 percent point less credit. Furthermore, belonging to a network is a decisive factor, adding 10-20 percent point more credit. Within a network, it is easier to acquire information about a business partner, plus the opportunity for community sanctions is enhanced. This gives the supplier a certain power and therefore motivates a supplier to take more risks and give more trade credit. According to official statistics, private entrepreneurship in the industrial sector contributed to 24.6 percent in 2000, increased to 37 percent in 2005. Since a part of small-scale private business activities take place in the informal sector, economists argue that their real contribution is *de facto* even higher.

Entrepreneurs in China and Vietnam have operated under immensely difficult circumstances. Informal institutions have served as a viable alternative for the lack of formal institutions.

Relational contracting based on trust and repeated business interaction substituted for an efficient contract law, business disputes were handled personally so that a court system was not utilized. The incentive structure that encourages collaborative and honest business behaviour and discourages opportunism was stabilized through the development of close-knit community members in which gossip and community sanctions was a powerful tool. Nonetheless, according to many academics, these informal mechanisms rapidly reached its limitations since. Therefore, they only explain how private business activity was possible but not the extent to which it has gained importance within the national economy. In order to understand how these small-scale entrepreneurial activities that mainly produced simple products have become such a valuable and indispensable sector. One of the key challenges for entrepreneurs in China and Vietnam were the stigmatization of being an exploiter and capitalist. When it comes to informal institutions, Chinese and Vietnamese entrepreneurs relied on very similar social mechanisms such as relational contracting, network building, and trust-based collaboration.

3.2.3. Case study: Private firms in HCMC

In order to determine a trend in PSD in Vietnam and to compare it with previous research about the business environment of private entrepreneurs, a survey is conducted among private firms in HCMC. Fifteen managers were surveyed in total. Due to the extremely small sample size, the survey is neither representative, nor can be empirical evidence drained out of the results. However, it reflects the perspective of businessmen in HCMC and gives an overview how their business environment looks like. Since it is a non-representative survey, the approach is reverse to regular analysis. Instead of drawing conclusion from the results, expected results are formulated beforehand based on previous research analysis which in essence. According to previous research by McMillan and Woodruff, private businessmen in Vietnam operate within an antagonistic framework. Trust in law enforcement is weak and the bureaucratic burdens are high. Therefore, I expect the survey results to paint a similar picture.

Contrary to expectations, 10 out of 15 firms obtained a bank credit to finance their business operations, with trade credit provided by suppliers being the second most frequently chosen answer. Additionally, the respondents were asked to rank the factors that influence their decision to choose a new supplier. The majority has stated quality, price, and supply time of the products as the most influential factor. Based on previous studies, the most influential factor would have been expected to be recommendation by friends. One of the most unanticipated results was the trust in the legal system. The result of 6.8 is a rather high value

particularly taking in consideration the bad reputation of the Vietnamese legal system. 40 per cent rated an 8. This might show a trend that the legal system has made improvement regarding law enforcement.

However, many results comply with the assumptions about Vietnamese business practices. For instance, two thirds of the surveyed managers stated that they typically find their suppliers through *personal connections*, which is the most frequent answer, closely followed by *recommendation of friends* with 58.33%. This emphasizes the importance of personalized networking in finding business partners. Also, it appears highly possible for firms to find out in case they have been deceived by their suppliers (6.5) which indicate that they have relatively effective means to gain information about other firms within their network.

Another result that is compliant with the analysis is the methods used to handle business disputes with suppliers whereby several answers were possible. A vast majority of over 80 per cent prefers to negotiate and find a solution between the two parties involved while only one respondent would choose to go to courts or file a lawsuit. This illustrates the preference for informal problem solutions. However, half of the interviewees also seek advice from local authorities, indicating that they are not completely excluded from the private business world.

The results are slightly different when asking about disputes with customers. In this case solutions are almost exclusively worked out between the two parties. When it comes to finding customers, targeted advertisement is the most common method, closely followed by personal connections and recommendations. On average, the respondents know approximately 65 per cent of their customers, stressing the importance of personalized relationships.

Government agencies are found to be of little assistance in establishing the business. One quarter stated that they were *not helpful at all*, indicated that active promotion by the side of local officials is not common. A very interesting aspect is also how firms describe their relationship to the government. Half portrayed the relationship as friendly and mutually beneficial, one third answered that it is characterized by indifference and about 16 per cent prefer to avoid any contact with the government due to predatory behaviour. This indicates that the government attitude is mostly tolerating but it is difficult to draw any reasonable conclusions. The difficulty of starting a new business has been rated as a 4.6 which is not as low as expected. Taking a closer look at the specific obstacles there is a wide and fairly evenly distributed range of difficulties indicating that entrepreneurs face various kinds of challenges. Taking the average, the extent of connections to the government as well as

connections to friends and family members on benefiting the business has been rated with the same value (6.5).

In summary, the survey results do not entirely confirm the expectations. The reliance on personalized relationship is slightly weaker than anticipated whereas the government plays a more significant, and more importantly, more positive role. Although it is problematic to interpret the results due to the small number of surveyed people, it might point towards a small progress concerning government support and legal system. A similar study covering more firms throughout the whole country

3.2.4. Regional clusters

In the past two decades, industrial clusters centred around private entrepreneurs and coordinated by local governments have mushroomed in rural areas. These clusters endogenously developed through the extensive imitation of successful business ideas, leading to a dense network of firms which often manufactured the same products. There are three distinct types of industrial districts in China: The Wenzhou model, the Sunan Model and the Pearl River Delta Model (PRD), each one following a different development path. When analyzing regional clusters in Vietnam, three industries are of particular importance: garments, consumer electronics, and motor vehicles (Sakata 210). They were focus in the cluster study by McCarty et al (2005), plus were selected as priority industries, receiving extra support.

Wenzhou Model

Some scholars argue that the rise of China was essentially led by private business activities that primarily took place in selected localities. One of the most prominent examples of regional clusters in China started as small family-owned business in Wenzhou, Zhejiang province which is nowadays considered as the pioneer of PSD (Wei, Li, Wang 2007). Wenzhou's initial conditions appear far from ideal for economic growth. It was an extremely poor area. The low rate of government investment proved to become an advantage by leading to less SOE orientation and therefore allowing marketization more easily and openly. Private businesses were often established as a last resort since there were few prospects to gain income, mostly operated in the informal sector or were registered as TVEs. In the beginning of reforms, entrepreneurs in Wenzhou struggled with many obstacles. Not only were basic resources missing such as technology, market information, infrastructure, and financial capital, but they became the target of state suppression. Therefore, entrepreneurs relied on

their local networks to provide them with basic necessities such as small loans and information. In the beginning, the attitude of the local government towards these semi-legal activities ranged from indifference to tolerance and even support, simply because they welcomed any kind tax revenue. The success of private businesses is also attributed to their business culture that praises mercantilism and encourages entrepreneurial spirit.

The industrial district in Wenzhou has undergone a restructuring process since 1980s. Formerly centred on small family businesses, the industry is now dominated by larger firms and MREs with “networks extending nationally and globally”. Wenzhou has become a role model for other poor areas and remains a symbol of ... but the sustainability of this model has been questioned recently. In 2002 and 2003, the growth rates have become lower than the provincial average. One of the main struggles is the custom of sticking to labour-intensive, simple products instead of moving up the technological ladder. The strength of the Wenzhou model, namely running business based on trustworthy social networks, becomes a weakness when trying to maintain their competitiveness and integrate into the globalizing economy. The local networks consist of strong, personalized bonds between various trade partners, making it difficult for outsiders to join and to extend business (Wei, Li, Wang 2007).

However, it is a prime example for a flourishing bottom-up development whose enormous success quickly spread around the country, inspiring other regions to drive for prosperity by following the Wenzhou model.

Garment industry in Ho Chi Minh-City

One specific case in Vietnam that accurately exemplified the importance of informal institutions for the economy is the garment industry in Ho Chi Minh-City. In HCMC, the private sector is the biggest contributor. There were 1,399 non-state enterprises, comprising 57% of the total garment industry in Vietnam in HCMC and the sourcing area (Sakata 2010). Within this sector informal subcontracting between a large supplier and micro-level subcontractors play a major role. The following results are based on a field work in 2002-2004, as well as in the year 2009. Despite the small sample size of 21 suppliers, this research offers valuable insights due to its in-depth data and information collection, focusing on personal relationship with their business partners.

The findings suggest that due to the informal nature of business affiliation, the relationship often extends to a financial relationship. Subcontractors are typically dependent on their original contractors' credits and loans as a financial source (Goto 2013). The study concludes that the personalized linkages and high reliance on informal institutions is an overall positive contribution. They benefit original contractors with low processing fee payments and thus high profits, plus provide subcontractors with essential loans that they could not have obtained otherwise. The fact that some original contractors have started as subcontractors and evolved throughout time indicates a virtuous circle that significantly facilitates the entrance of private entrepreneurs in complete absence of market-supporting formal institutions. The garment industry is also an interesting example because it has been found to have the greatest tendency to cluster in Vietnam (Sakata 2010). This case contains valuable lessons. Almost all subcontractors and micro firms that are an essential contributor to the local economy are not registered, meaning that conclusion solely based on official statistics may convey an incomplete picture.

Comparison

Industrial clusters have emerged in both countries. Both the Chinese and Vietnamese PSD originally started small-scale in poorer areas with little to no supportive institutions. An important feature in China which is missing in Vietnam is the emergence of a hybrid type ownership, the TVEs that have facilitated a smooth transition to a market economy. Otherwise, there are many similarities observable, from the early struggles against predatory behaviour of the government up until the reliance on kinship based close-knit communities for survival. Still, the private sector as it is today differs from one another. There is a great qualitative difference. The Chinese regional clusters have successfully integrated into the value chain, exporting their products to the global market. In contrast, the wide-spread practice of subcontracting in Vietnam may eventually produce export goods in the end, but it appears less organized. Furthermore, the formal institutions stressed by NIE such as property rights are further developed in China. The more sophisticated stage of the private sector in China can surely be attributed to the supportive attitude of the local government. Even after TVEs declines and purely private firms emerged, local officials remained involved as a legacy. Conversely, Vietnamese private entrepreneurs did not enjoy the same support of the local government. The divergence of the private sector growth indicates that formal institutions are necessary in the long-run.

There are valuable lessons that can be drawn from the PSD in China and Vietnam. First of all, the studies of information institutions are vastly underrepresented in conventional economics. Although NIE acknowledges the importance of informal institutions, the theories remain rather superficial and broad, sophisticated models and resulting policy recommendations are missing. An incomplete understanding of the specific mechanisms of informal institutions and their development will improve the quality of policy recommendations for developing countries that are suffering from ineffective formal institutions.

What government can do to maximize the full potential of industrial clusters based on informal networking is the provision of infrastructure leading to urban markets. Another issue is the weak linkage between small and medium-sized enterprises and state-owned enterprises, as well as large multinational corporations that prevents important FDI spill over effects on the local economy. Since they mainly operate on the domestic market they certainly strengthen domestic capabilities. But in order to further grow and penetrate more sophisticated sector, the domestic firms must develop strong absorptive capacities.

Informal institutions have defined every aspect of the private sector development, particularly in the early stages. One of the most crucial institutional changes in the long-run was the declining stigma of private entrepreneurs and the simultaneous rise of social recognition.

4. Concluding Remarks

First of all, an accurate assessment of PSD in China and Vietnam represents a major challenge. Official statistics are often highly unreliable, particularly in earlier periods. Moreover, private firms have often registered under another classification to avoid discrimination which further blurs the actual picture. Another issue is the regional disparities within the country, for instance is the difference between Northern and Southern Vietnam immense. Additionally, another difficulty with the topic in general is the fairly recent growth of the private sector. The long-term development need to be assessed in the future. According to the before mentioned theories about the interaction between formal and informal institutions, a misalignment of interest between the members of the society and the state poses a major problem. This divergence definitely existed when examining the private sector in a communist society which is the case in both China and Vietnam. The actual development mostly took place before the accompanying policies were introduced, making policy recommendations difficult. The most important information to keep in mind regarding the private sector in China and Vietnam is that in the beginning they developed in complete

absence of market-supporting formal institutions and were even discriminated against by the government and society. Nonetheless, private entrepreneurs have developed informal institutions to reduce risks and they have led to the emergence of important regional clusters and developed into a major engine for the economy. By continuously relying on informal institutions such as social networking, relational contracting, informal trade credit, they have continued to grow and slowly won social recognition and political legitimacy, changing the institutional environment in their favor.

Effective rule enforcement can surely benefit business operations. Still, important to note is that the early development of private business activities would have not been possible without the rather ineffective enforcement and lax monitoring. This emphasizes the strength of the government's experimental approach in which laws leaves room for interpretation. Paradoxically, this lenient approach to laws can develop into a great issue in the future when efficient formal institutions are needed to protect entrepreneurs' rights.

From the institutional perspective, the PSD in China and Vietnam is an interesting case. Clearly, it is a bottom up development that has emerged rather spontaneously, driven by private entrepreneurs. Neither the government nor any other higher authority played a significant role in the beginning, but only reacted after the process has taken place. In retrospect the reaction was favourable in the long-run although Chinese local governments appear to be more involved and intertwined with the small businesses compared to Vietnam.

Determining the right institutions are one of the most problematic challenges. The academic community widely agrees that efficient formal institutions are necessary in the long-run. Both China and Vietnam have made serious efforts in modifying their legal framework and upgrade their systems to international standards. However, enforcement issues remain, particularly in Vietnam. Wide-spread corruption is common practice and trust in the legal system is weak. The analysis of the PSD reveals how insufficient the theories of NIE are in providing an understanding of bottom-up developments. Although NIE provides a fairly realistic and profound basis for explaining economic development, it is indeed still in an infant stage and needs additionally modifications and extensions. The main critic point refers to the overemphasis of formal institutions in the literature, while the complexity of informal institutions is only superficially touched. Particularly when dealing with transition and developing economies with imperfect formal institutions, this mistake can be fatal. Furthermore, since policy recommendations typically refer to formal institutions, the decision-makers need to take into consideration the specific context, just as Rodrik and North

have emphasized. Formal institutions that are not compliant with the existing informal institutions are highly unlikely to be effective and sustainable.

The analysis of the private sector development in China and Vietnam reveals that it has emerged in virtual absence of formal institutions. The explanation why the private sector growth was possible in the first place can be traced back to informal institutions that have served as a practicable substitute. Private entrepreneurs have overcome severe obstacles by establishing close-knit social networks in which sanctioning and reward mechanisms efficiently worked.

Furthermore, the analysis demonstrates that conventional economic theory such as *New Institutional Economics* prove to be insufficient in explaining the phenomenon. Instead, elements of *Economic Sociology*, that put a stronger emphasis on social relations between individual actors, offer a more adequate explanation for the power of informal institutions. In conclusion, this study field is recommended to be fully integrated into economic models.

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6. Appendix

Survey

1. Please State your full name.

2. What is your job position?

- self-employed
- CEO
- General Manager
- Middle Manager
- Clerk
- Other: _____

3. What is the firm's ownership type?

- State ownership
- Common Ownership
- Private ownership
- ownership by political organization
- Other: _____

4. How many employees does the firm approximately have?

- 1-7
- 8-20
- 21-50
- 51-20
- 200+

5. What city is the firm located in?

6. What is the firm's industry type? (Several answers possible)

- Agricultural Products
- Manufacturing
- Retail
- Service
- Finance
- Other: _____

7. What year was the firm established?

8. How are the business operations mainly financed? (Several answers possible)

- Bank credit
- Trade credit
- Informal credit
- Own savings
- Other:_____

9. Where is your major market? (Several answers possible)

- within the city
- within the province
- within Vietnam
- Overseas

10. How do you usually find suppliers? (Several answers possible)

- Targeted advertisement
- Online search
- Government support
- Personal connections
- Recommendation of friends
- Other:_____

11. Please guess between 1-10: If your supplier deceives another firm, how high is the probability of you finding out? (1 being “very low” and 10 being “very high”)

12. Which factor influences your decision of choosing a new supplier? (1 being “most important” and 10 being “least important”)

- Own experience
- Good reputation according to my business partners
- Good reputation according to my friends and family members
- Quality, price, and supply time of the product

13. How does the firm typically handle business disputes? (Several answers possible)

- We never have disputes
- Ignore disputes
- Negotiate and find a solution between you two
- Seek advice from local authorities
- Go to court/ file lawsuit
- Other:_____

14. How do you usually find customers? (Several answers possible)

- Targeted advertisement
- Online search
- Government support

- Personal connections
- Recommendation of friends
- Other:_____

15. Please guess and state in percentage %: How many customers to you know in person?

16. How does the firm typically handle disputes with customers? (Several answers possible)

- We never have disputes
- Ignore disputes
- Negotiate and find a solution between you two
- Seek advice from local authorities
- Go to court/ file lawsuit
- Other:_____

17. Please rate between 1-10: To what extent did government agencies or government officials assist in establishing the business? (1 means “not helpful at all and 10 means “very helpful”)

18. How would you describe the firm’s relationship to the government?

- friendly and mutually beneficial relationship
- predatory behavior of the government, thus prefer to avoid them
- no/ indifferent relationship
- Other:_____

19. Please rate between 1-10: How difficult is it to start a business in general? (1 means “very easy” and 10 means “very difficult”)

20. Please rank the obstacles to business establishment according to their level of difficulty (1 is the biggest obstacles, 7 is a minor obstacles)

- license acquisition
- credit access
- lack of technology
- lack of human capital
- lack of market information
- lack of financial capital
- other administrative problem

21. Please name other obstacles if they had not been mentioned before! (optional)

22. How would you rate the importance of personal connections to government officials in order to successfully doing business? (1 means "not important", 10 means "extremely important")

23. To what extent do your personal connections to friends, family members, and acquaintances benefit your business? (1 means "not beneficial at all", 10 means "very beneficial")

24. How much do you trust in the legal system to enforce your rights in case of contract violation or other business disputes? (1 means "no trust at all", 10 means "very high trust")

25. What is your most important asset? Please rank them! (1 is "most important" and 5 is "least important")

- technology
- human capital
- government connections
- reputation
- personal connections

26. Please name other important assets if they have not been mentioned before! (optional)

27. Any further comments? (optional)
