

Hard Regulations and Soft Constraints: China's Institutional Crisis and Models for Change

Yong Cao, Associate Professor of Marketing, University of Alaska Anchorage

Ed Forrest, Professor of Marketing, University of Alaska Anchorage

Paul Johnson, Associate Professor of Economics, University of Alaska Anchorage

Rashmi Prasad, Associate Professor of Management, University of Alaska Anchorage

ABSTRACT

Following years of rapid economic growth, China currently faces a crisis of its economic institutions. Unconstrained business behavior has led to the accumulation of externalities with high social costs. In this paper we consider the challenges of institutional change that China faces, especially the need to evolve a system of 'hard constraints' reinforced by 'soft constraints'. We describe the U.S. experience in evolving economic institutions through periodic crises of its economy, and analyze the importance of the U.S. experience as a model for contemporary China. We suggest that China's institutional evolution is likely to be eclectic, drawing on international models, but still largely rooted in the 'civilizational logics' that are deeply embedded in the country. Thus, the current revival of Confucian ideals in China is likely to prove significant in informing the process of institutional change that is currently underway.

Keywords: China, Institutional Change, Business Regulation, Confucianism

INTRODUCTION

As an economy transitioning from centralized planning to a market driven system, China has experienced unprecedented growth, wherein for the past quarter of a century the annual GDP growth rate has averaged above 10%. Impressive as this statistic appears, it only reflects the quantitative dimension of economic growth (as measured by the market value of all goods and services produced annually). Concomitantly, there is a qualitative side of economic growth as well. Herein, we measure the degree of growth (maturity) of a country's legal, regulatory and financial systems. Academic literature has indicated that sustained economic growth, especially beyond low levels of per-capita GDP, correlates most highly with the quality of institutions and "in particular the role of property rights and rule of law. In this view what matters are the rules of the game in a society and their conduciveness to desirable economic behavior" (Rodrik, Trebbi, Subramanian 2002: 3). It is thus not surprising that rapid economic growth has led to the emergence of an institutional crisis. What remains in doubt is whether the country will be able to develop institutions to cope with the externalities created by rapid economic growth.

China's legislation and law enforcement system in general and its business and commercial laws in particular remain underdeveloped. Since the introduction of market reforms, China is on pace to become the world's largest economy. However, China's market economy faces a serious challenge regarding the development of its ethical and legal 'infrastructure.' China's economic development is experiencing tensions between the goal of rapid growth and popular demand for restraints on the adverse consequences of that growth. With local government dependent on local businesses for revenue, provincial and city officials have been reluctant to bring corporations to task for polluting, safety violations, or fraud. Frequently, business interests seem to be unchecked and unregulated by countervailing institutions. As a result, corrupt business practices, which focus on short-term profit gains instead of long-term sustainability, are becoming more prevalent in the society. China's market system has been described as 'capitalism with the gloves off' – similar to the nineteenth century 'robber baron' period in the United States. A recent case in point is evidenced by The Industry and Commerce Administration of Zhejiang which issued the "three no's" policy. Two of the no's dealt "with minor licensing and registration issues... the third one, though, states that there should be no punishment for businesspeople that make "common violations that don't directly cause harmful consequences." Instead

they should be given suggestions and admonitions to correct their errant behavior". The reaction to such edicts demonstrates the on-going concern for and intent to bolster china's ethical and legal infrastructure:

"... too much freedom for local authorities to interpret the policy, which is not a good thing," said Liu Kaiming, director of the Institute of Contemporary Observation at Migrant Workers Community College in Shenzhen. "I mean, I don't know what kind of small crimes or illegal things would be let go. Is it tax evasion, labor rights, pollution?" (Lee 2009)

In the current Chinese business environment, laws do exist that protect consumers, protect the environment, and regulate commerce. But the enforcement of these laws is ineffective and coverage of the law is not comprehensive. For example, since China has no antimonopoly law, consumers who object to price-fixing must attempt to work through the national Price Law. In addition to gaps in the framework of law and regulation, the central government's capacity to implement and enforce has declined. The logic of economic reform in the Deng Period (Shirk 1993) was to rely on localization and devolution of authority, in order to end-run opposition at the central government levels. Thus, despite that fact of the existence of a formal scalar chain of command or *xitong* that unifies national and local government ministries, in practice central ministries exercise limited control over subsidiary levels of government.

In this paper we describe the institutional crisis facing China's economy by placing it in comparative perspective with the evolution of other major economies, especially the United States. Based on this comparative perspective, we argue that while institutional change involves trial and error, and selective bricolage drawing on the experience many other countries, China is likely to evolve a system of 'structured pluralism' that is consistent with other East Asian Capitalist nations. Thus, we also envision that Confucian ideals and concepts are likely to play a significant role in the process of institutional change and re-invention as the Chinese economy evolves.

Hard vs. Soft Regulatory Approaches for Structuring China's Market System

It is commonly understood that the proper functioning of a market economy requires constraints on human behavior. These constraints are both 'hard' and 'soft.' *Hard constraints* are regulations and laws, including legal property rights and enforceable contracts. Hard constraints include a system of laws, and institutions to enforce them. *Soft constraints* are values and ethical norms of behavior. Soft constraints includes values (traits and ideals considered desirable and held in a positive regard), morals (principles of right human character or conduct), ethics (a philosophy of what is right or wrong in conduct), and norms (rules, standards and patterns that dictate behavior).

Both hard and soft constraints are necessary elements in the functioning of a complex society by nature of the fact that they complement and reinforce each other:

- First, soft law norms can strengthen hard law, by supplementing it or by filling gaps in the law.
- Second, soft law norms can act as a precursor to the evolution of binding legal rules.
- Finally 'soft' responsibility can arise from the operation of soft law norms, in much the same way as ordinary responsibility. (Footer, 2008)

Luo Haocai (vice-chairman of the National Committee of the Chinese People's Political Consultative Conference until March 2009 and current president of the China Society for Human Rights Studies) describes the interplay between hard and soft law in China:

These days law generally takes the form of "hard law," which is codified and mandated by the state. But there are also rules and norms that don't take the form of codified law, such as custom and precedent. This is what we mean by soft law. Soft law exists in every society, but it has played a more prominent role in China than elsewhere because the hard-law framework was less developed in China. (Symposium Report, 2008)

As the market economy matures, it is incumbent on China to develop soft (non-mandatory) law in addition to hard (mandatory) law. As Luo (2008) observes, "in a complex environment, a combination of soft and mandatory measures should be used and there have been successful explorations in many areas. The administrative law and the diversification in public administration have changed the old pattern of controlling everything through administrative management:

China does not try to achieve social transformation overnight but seeks a gradual progress. A consultative mechanism with Chinese characteristics and a mixed governance model that combines soft with hard laws has been created....

In general, China has already begun to form a model for protecting and improving the environment that combines both soft and hard laws. It emphasizes the hard laws by improving the environmental-protection legal system, strengthening law enforcement, acting in strict accordance with the law and closing down a large number of companies with backward production facilities. (Luo, 2008)

The experience of industrialized nations suggests that the process of overcoming institutional crises of capitalist economy is a decades- long, emergent phenomenon involving conflict, trial and error, invention and borrowing. The time-scales and scope of institutional change involved are well-illustrated by the institutional evolution of the U.S. economy, which we describe below.

Hard Regulations and Soft Constraints on Corporate Behavior in the United States: A Historical Review

Examining the experience of the United States, one finds four distinct stages of development regarding commercial and regulatory governance:

Stage 1: Unregulated before 1890s

The debate between advocates of a strong, centralized state, as represented by Hamilton's classic mercantilism, and those favoring individualism, self-determination, small economic scale and decentralization transpired at the very founding of the United States. Advocates of the former position including Franklin, Jefferson and Jackson prevailed, and the country's policies favored individual pursuit of property and accumulation, not least in encouraging the settlement of new territories with homesteading laws. Technological limitations kept firms small, until the railroads and telegraph physically enabled national markets and large firms (Chandler 1977). The emergence of large scale enterprise, especially the railroads and grain elevators, created a great power asymmetry that disfavored farmers and small businesses, creating a populist backlash that lies at the root of national economic regulation in the United States.

Stage 2: Economic Regulation of Firms and Markets

Largely motivated by a desire to curb market power, this stage witnessed the emergence of regulated markets in the U.S. Towards the later part of the nineteenth century, unrestrained business influence came to be seen as a threat, not only to the market system, but even to democratic values. If ordinary people were to maintain political sovereignty, powerful corporate interests would have to be contained under a system of law and regulation. Business law, which had emphasized contract and tort law, began to include antitrust and general consumer protection. Anti-trust legislation was promulgated, beginning in the late 19th century with the aim of promoting a competitive environment by checking the trend toward monopolies and cartels (Sherman Antitrust Act, Clayton Act, and Federal Trade Commission Act). Regulating market channels began during the depression era of the 1930's with the purpose of protecting independent merchants against competition from larger chain stores (Robinson-Patman Act was the key legislation towards this end).

It must be noted that regulation of the U.S. economy was achieved with the indispensable role of the courts and judiciary. The country lacked a unified and integrated civil service to implement economic regulations, due both to its size and government structure. The critical Anti-Trust laws and regulation were not utilized primarily by Commerce and Treasury departments, but by Justice using the courts as an arena to fight out and enforce public policy. This history contrasts with smaller countries like France in which an elite, national civil service guided economic development, and poses important questions for China, which had re-constituted effective centralization of the state in the first decades of the People's Republic (following on the disintegration of the early 20th century), only to have the trend reversed during the Deng period, in the pursuit of economic liberalization.

Stage 3: Social Regulation of Business:

This stage began mainly in the 1960s, reflecting the conjuncture of several major trends, including the declining trust in the paternalism of government and business, emergence of 'post-materialist' values (Inglehart 2005) as a result of high levels of affluence. These resulted in an assertion of civil-society in the form of new social movements, such as those advocating environmental protection, consumer safety, and occupational safety. Government responded with the creation of a substantial number of executive agencies to oversee these new areas of social concern: FDA, EPA, OSHA, Consumer product safety, etc...

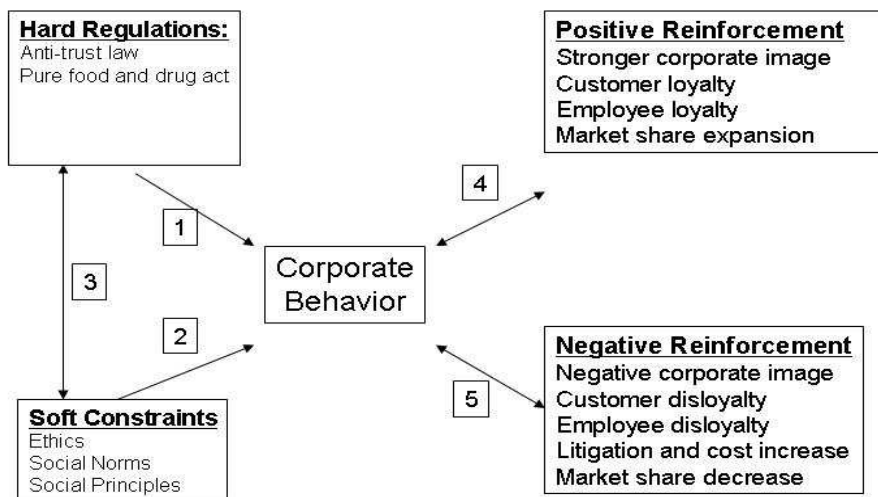
Stage 4: Flowering of Civil-Society, soft regulation and emergence of ‘Private Politics’ to promote corporate social responsibility:

Larger NGOs such as AARP, World Wildlife Fund engaged government policy arenas (lobbying legislators, executive agencies, or engaging in public interest litigation), but many found these arenas asymmetrical, favoring the greater resources of corporations. As a result innovative NGOs skillfully pioneered ‘private politics’ (Baron 2003): the influence of corporate behavior through the arena of public opinion. The case of the NGO Rainforest Action Network and its influence of CitiGroup, was an exemplary instance of a civil-society actor deftly exercising the power of soft constraints to achieve its aims. Other noteworthy practitioners of private politics and enforcers of soft constraints include the National Coalition Against Misuse of Pesticides, PETA, Special-interest groups, American Association of Retired People (AARP). Additionally, industries in the U.S. often constitute self-regulatory bodies, such as the Motion Picture Arts Association, or the Joint Commission for the Accreditation of Healthcare Organizations to forestall direct government oversight.

In the U.S., as in all mature market economies, both hard regulation and soft constraints such as ethics, social norms and social principles are well developed and complement one another in the regulation of corporate behavior. Consumers and customers have strong power to participate the market for information exchanges and transactions. Additionally, civil-society is highly organized and has developed effective means of influencing corporate behavior with soft constraints. The most sophisticated practitioners of ‘private politics’ has managed to harness the market’s dynamics to promote corporate social responsibility.

As illustrated in Figure 1 (below) a good corporate citizen complying with hard regulation and soft constraint, will be able receive positive reinforcement in the market with stronger corporate image, higher customer loyalty as well as employee loyalty. Consequently, the firm will be able to expand its market share and increase its growth rate. On the contrary, a bad corporate citizen which does not comply with hard regulation /or soft constraint, will be punished by the market with negative reinforcement and a negative corporate image, its customers and disloyal employees. A poor corporate citizen will experience a long-term litigation process, associated costs will increase dramatically and market share will drop precipitously.

Figure 1. Hard Regulation and Soft Constraints in a Mature Market Society



In a pre-mature market economy, hard regulations are undeveloped or underdeveloped. The market has very limited signaling power. The business interests with the combination of (local) government's support dominate the market. The citizenry and consumers have limited power to participate the market for information exchanges and transactions. Soft constraints such as ethics, social norms and social principles tend to have downward trends with no power to regulate firm's behavior. In this system, a poor corporate citizen that does not comply with soft constraint (also without the limit of hard regulation), will not be punished by the market through negative reinforcement, on the contrary, it will be able to rapidly establish a dominant market position. Moreover, businesses that do comply with traditional soft constraint, are less likely to receive positive reinforcement and in competition with the non-compliant business may gradually lose market position.

Evolution of China's Economic Institutions: Convergence on U.S. Model?

Drawing on the above historical review of the U.S. experience China's regulatory evolution could be characterized as being between stages 1 and 2 – not completely unregulated but still short of a mature business environment focused on hard regulation of unrestrained capitalism with a emerging system of effective ethical constraints. Additionally, China's current challenges are greater than those faced historically by the U.S. when it transitioned from stage 1 to stage 2. Issues such as environmental pollution, which the U.S. system had to tackle many decades after it instituted a robust framework of economic regulation, are pressing upon China at its present stage of development.

Table 1: A Comparison of U.S. & China Government Regulatory Agencies

Area	United States Enforcement Agency	China Enforcement Agency
Monopoly	Federal Trade Commission	No antimonopoly law currently exists
Consumer Safety	Consumer Product Safety Commission	Not Currently Addressed
Environment	Environmental Protection Agency	State Environmental Protection Agency with limited power Accorded Priority in proposed state reorganization of 2008
Labor and Employment Practices	National Labor Relations Board Equal Employment Opportunity Commission	Labor Contract Law of 2008 Enforcement currently uncertain.
Financial Markets	Securities and Exchange Commission	Under Jurisdiction of National Development and Reform Commission
Credit Practices	Federal Trade Commission	Under Jurisdiction of National Development and Reform Commission

Economic development in all advanced countries has been accompanied by the development of increasingly sophisticated public and private institutions, in order to resolve a greater range of conflicts and facilitate more rapid structural transformation of the economy. There have been multiple paths to achieve and implement such institutional change: from the centralized, civil-service driven model of France, to the decentralized, judiciary driven experience of the United States, to the structured pluralism of East Asian capitalist nations. In the U.S. the executive arm of the state was comparatively weak, especially in the institutional crisis that bridged stages one and two, hence the importance of the legislative and judicial systems in inventing institutions that curbed market power. In Japan, on the other hand, the state bureaucracy played a greater role in generating and enforcing institutional changes. China currently stands at a crossroads of its development. According to Rodrik, its growth has been so rapid, that it is fast approaching an institutional bottleneck or crisis. Comparison with the experience of industrialized nations suggests that there is no one single means of attaining institutional change. Which pattern is China likely to follow in the development of its institutions?

Early 'Modernization Theory' expectations of a world-wide convergence on the American model were belied by historical experience. Scholarly studies of East Asian capitalist institutions (Orru, Biggart and Hamilton 1997) have argued that viable, yet culturally embedded forms of capitalism have emerged in Asia. Rather than importing western institutions wholesale, Japan, S. Korea and others have adapted these to local conditions. Hamilton (1994), reasoning from a Weberian perspective, argues that enduring 'civilizational logics are embedded in institutional spheres of activity where they provide orientations to action.' The PRC, despite the revolution, remains within the orbit of Confucian-East Asian civilization, and is more likely to innovate institutional solutions for its evolving economy that work within the logic of its broader 'civilizational logics'.

As their economies evolved and diversified, Japan and S. Korea's institutions evolved to accommodate greater degrees of pluralism. The systems evolved in these countries did not converge on the U.S. model of a more wide-open and competitive pluralism. Rather, the 'structured pluralism' they developed was consistent with East Asian tradition in which "organizational principles rest on the development, differentiation, and systematization of normative relationships...in the West laws regulate the actions of people, norms in Asia order the relations among roles. The Chinese emphasis on a hierarchy of ordered relationships and on harmony among those relationships formed a powerful worldview for creating social, political, and economic institutions" (Hamilton 1994: 198). Although China is an authoritarian state, it is beginning to manifest elements of 'structured pluralism' (Baron 2008). Take the example of the popular pressures that resulted in the enactment of the Labor Contract Law:

...Workers in China complained of harsh working conditions, unfair dismissals, failure to make severance payments, and failure to pay overtime. In 2007, parents of 400 children posted a letter on an internet site describing how they had rescued 40 children who had been kidnapped and sold as slaves to work in brick kilns in Shanxi province. Local government officials, however, prevented the families from locating more of the children. Outrage broke out in China, and the government sent 35,000 police to the area to search 7,500 workplaces. The police rescued and released nearly 1,000 workers, many of whom were dazed, bleeding and exhausted. Pictures of the released men and boys added to the popular anger. This incident provided the final impetus for legislation to establish certain rights for workers...The Labor Contract Law requires an employer to give a contract to a worker within one month of employment. (Baron 2010: 539).

The Chinese state is currently undergoing considerable change and struggle to adapt to the many challenges thrown up by rapid economic growth. Currently national ministries are being restructured and integrated to cope with crises such as environmental pollution. There is a struggle between central and local authority, which may result in reversing the devolution trends that began in the Deng period. Additionally, the Judiciary, traditionally one of the weakest segments of the PRC state, is increasingly becoming a venue for resolving citizens disputes (Baron 2010).

Confucianism and Institutional Change in China

Confucian ideas are enjoying a revival with state sponsorship after a long period of decline in China. Confucian thought and ideals have the potential to support the efforts of institutional change agents in China, provided they are able to mobilize and influence others by effectively framing their messages. This would represent a 'full-circle' change in the country, as Confucian ideas were once castigated for holding back China and leading to its supplication before foreign powers. Additionally, Confucianism has a host of contemporary critics who argue that it is incompatible with many modern institutions such as democracy; autonomous civil society and profit-seeking behavior (see Chan 2000). Despite such criticisms, Confucian philosophy remains the most deeply rooted civilizational meta-narrative in Eastern Asia, including China, and therefore remains a powerful vehicle for addressing people at the level of their values, ethics and norms.

Analysts who are skeptical of Confucianism's adaptability to a modern context, are typically ignorant of the role of ideas in fostering change in the political economy. Institutional reformers generally don't attempt the wholesale implementation of abstract ideology or philosophical systems. Instead they engage in a process of "bricolage, through which they recombine already available and legitimate concepts, scripts, models and other cultural artifacts that they find around them in their recombination of old institutional elements in new and socially acceptable ways." (Campbell 1998: 7).

An ethical code, based on the writings and oral tradition concerning the teachings of the scholar K'ung-fu-tzu (literally "Master Kung") in the period 551- 479 BC, Confucianism provides considerable raw material for institutional entrepreneurs and change agents; it has a vast literature with considerable legitimate appeal. While there are different schools of Confucian thought, there are certain common themes. Confucianism emphasizes social harmony and right behavior. The virtuous 'gentleman' will act with humility and honesty toward others, and respect for natural law. He will exhibit filial loyalty toward his parents and benevolence toward his children. The ethical person will exhibit 'jen' – recognition of the value of others, irrespective of their rank or class. Another concept is 'li' – ideal conduct in terms of propriety, reverence and courtesy. Confucius also placed great emphasis on honesty and probity among government officials. In contemporary China, Confucianism has a powerful role in conceptualizing good government, state reform, and criticizing the behavior of local levels of government. This could strengthen the hands of reformists within the state structure and CCP. It could also lead to strengthening the Judiciary. Cheng (1998) argues that Confucianism does not conceive a role for civil-society (including business or NGOs). Cooperative, and deferential relationship between an ethical government and subordinate groups is enough. Thus, as an ideology it serves the interests of state-led reform, which, as the Labor Contract Law case illustrates, may involve aligning with mobilized social forces.

It has been suggested that perhaps the most central role Confucianism can play in the development of China's ethical and regulatory infrastructure derives from its lessons in conciliation and harmony which are embodied in the practice of the consultative mechanism of "xieshang:"

Viewed historically, xieshang is associated with such key Confucian values as conciliation and harmony, which the Chinese people continue to embrace even today.... the xieshang mechanism can make an important contribution to the development of democracy in China.... (Symposium Report, 2008)

The need for and nature of commercial regulation and constraints is already being formally addressed ten times a year when the "the ruling Communist Party but also eight other parties, as well as various other organizations, take part in the Consultative Conference, which holds deliberations concerning national policy, government personnel, and legal matters. In these conference sessions the participants discuss the issues Conclusions are reached on the basis of rational deliberation and persuasion, not imposed by government fiat. Furthermore, the same sorts of conferences function at the regional and business level, establishing local and industry codes and regulations through consultation." (Symposium Report, 2008)

Critics such as Cheng (1998) observe that there is no theory of the separation of powers within Confucianism, or of judicial review. However, we need not draw the conclusion that Confucianism has little to offer agents of institutional change in China. The country is currently passing through a phase of institutional crisis, and the process of institutional change will have to reflect the collective efforts of change agents engaged in creative acts of 'bricolage', drawing upon experience, tradition and models available from across the world. Luo (2008) provides one vision of institutional transformation :

China's social transformation means transformation from a planned economy to a market economy, from a single-sector system of public ownership to a system under which public ownership plays the dominant role and diverse forms of ownership coexist, from the rule of men to the rule of law, and from absolute, managerial government to limited, service-oriented government, from being closed or semi-closed to complete opening-up, and from a highly centralized structure of state and society to a dual structure... A consultative mechanism with Chinese characteristics and a mixed governance model that combines soft with hard laws has been created. Both hard and soft laws are basic forms of modern law.

The pace of growth in China has been unprecedented for a large, complex society, and has brought about a far reaching institutional challenge: the country must manage a variety of challenges that emerged more slowly in other countries, and were accommodated over many decades. The change process is likely to prove enormously challenging, requiring collective experimentation on an unprecedented scale. The outcome of this process remains uncertain, but it is likely to be consistent with East Asian patterns of 'structured pluralism' emphasizing strong norms of behavior and strong relationships (i.e. guanxi), rather than a Western model of independent legal jurisdictions.

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