

RENT SEEKING AND ENTREPRENEURSHIP: INTERNET STARTUPS IN CHINA

Tain-Jy Chen and Ying-Hua Ku

Against all odds, China has developed one of the most vibrant Internet industries in the world. According to Atomico (2015), which tracked venture capital (VC)-funded startups in the world, there were 156 Internet startups that had been founded in 2003–14 and that had become billion-dollar companies (based on market capitalization) by the end of 2014 after initial public offerings (IPOs). The United States leads the list with 86 companies, followed by China’s 30, and Sweden’s 5. All Chinese billion-dollar startups are consumer-related, while billion-dollar startups in other countries include business applications, games, and others. Similarly, the *Wall Street Journal* tracked unlisted VC-funded startups and identified 78 of them whose market valuation (measured by financing terms in the most recent round of funding) had exceeded one billion dollars in March 2015 (Table 1). The list includes startups in the Internet as well as other sectors. Again, the United States leads the list with 50 ventures, followed by China’s 8. All Chinese ventures are Internet-related, if Xiaomi, which tops the list of all startups and sells smartphones on the Internet, is also counted as an Internet company (Dow Jones Venture Source 2015). In short, Chinese startups are numerous, vigorous, and most successful in Internet-based consumer business.

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TABLE 1
CHINESE STARTUPS VALUED AT \$1 BILLION OR MORE,
MARCH 2015

| Company | Industry | Last Valuation (\$ billion) | Total Equity Funding (\$ billion) |
|-----------------|-----------------|--------------------------------|--------------------------------------|
| Xiaomi | Smartphone | 46.0 | 1.4 |
| Meituan | Group purchase | 7.0 | 1.1 |
| Didi Dache | Taxi app. | 3.5 | 0.828 |
| VANCL | Apparel | 3.0 | 0.512 |
| Kuaidi Dache | Taxi app. | 2.8 | 0.88 |
| Dianping | Restaurant app. | 2.0 | 0.569 |
| Koudai Shopping | Mobile shopping | 1.5 | 0.364 |
| Mogujie | Apparel | 1.0 | 0.2 |

SOURCE: Dow Jones Venture Source (2015).

Startups are manifestations of entrepreneurship and innovation. Vibrant startups indicate that the Chinese business environment is conducive to entrepreneurial and innovative activities. This is at odds with the general impression that China is nowhere near a business-friendly country. The Chinese institutions are considered inadequate or hostile to entrepreneurial activities. For example, the costs of starting a business in China are high, protection of property rights is inadequate, contract enforcement is lax, and financial market development is immature. Moreover, China ranks as one of the worst among the emerging countries in terms of corruption (La Porta et al. 2004), which fuels rent-seeking activities. It has been demonstrated in the literature that rent seeking undermines entrepreneurship (Baumol 1990; Murphy, Shleifer and Vishny 1990).

If rent seeking is prevalent in China, as suggested by the high-profile anticorruption campaigns in recent times, why are innovative activities so vibrant in the Internet industry? We argue in this article that rent seeking in the real sector actually encourages innovations in the Internet sector to uncover the hidden opportunities unrealizable in the real sector. Regulations designed by rent seekers always create distortions in the market, from which extra profits are generated. In China, such distortions are often reflected in above-normal prices, which benefit producers, especially large producers, while

depressing consumption. A stylized Chinese startup in the Internet industry creates a new business model that offers goods or services to satisfy unfulfilled consumer demand in the real sector. Low prices are a common feature of their business models. In China, Internet trade is analogous to the underground economy in other countries where small traders escape regulations. Despite the siphoning of talent and resources into rent-seeking activities, the fact that China is an open economy allows the local startups to tap entrepreneurship from international sources to undertake innovative activities. The startups also leverage international institutions to protect the value of their innovations. The sheer size of the Chinese market heightens the value of innovations, which in turn offsets the high risk of startup ventures.

Scholars often asked why private business activities remain robust in China despite weak institutions. The conventional explanation for this paradox is that informal institutions supplant the formal ones. For example, informal financial instruments make up for the weaknesses of the formal financial institutions in allocating financial resources (Allen, Qian and Qian 2005), and personal relations and informal contracts make up for the weak institutions in contract enforcement (Yu and Zhang 2008; Kwock, James and Tsui 2013). Internet startups are not a part of this story, however. The vitality of the Chinese Internet startups is not a manifestation of the working of informal institutions. Instead, the Chinese Internet industry functions under a set of private rules installed by the platform operators, who work as national champions to protect the domestic market from foreign penetration. The bureaucrats support and endorse such rules, which govern Internet trade more effectively than public regulations. More importantly, these rules reinforce rather than undermine the power of the state. The platform operators also invest in public goods that underpin the growth of the Internet industry. The Chinese Internet startups thrive in spite of weak institutions because they work under an umbrella provided by the platform operators. With a commitment to protect state interests, the platform operators are able to keep the government's hands off the market and therefore create a safe haven for startups. The umbrella contains a set of private rules that, while safeguarding the state interests, promote entrepreneurship and competition to enrich the platforms.

The remainder of this article is organized as follows. First, a theoretical background is provided for the relationship between the

state and entrepreneurship. Second, we discuss the unique combination of weak institutions and strong organizations that underlie the development of China's Internet industry. Next, we present a case study of Chinese Internet startups in taxi app, retail, and O2O (online to offline) businesses, highlighting the Internet economy as a complement to real sector deficiencies. Finally, we explain how the Internet platform operators create a favorable business environment for the Internet startups while compromising with the state interests.

The State and Entrepreneurship

It is well documented in the literature that the state has an important role to play in promoting entrepreneurial activities. The state has to establish and maintain good institutions that reduce transaction costs and risks in business undertakings. For example, institutions that protect property rights and enforce contracts are considered critical for the development of a market economy in which private enterprises play a major role in resource allocation (North 1990). While establishing and maintaining good institutions is important for the functioning of the markets, the state has to refrain from intervening in the markets if private enterprises are to thrive. The inclination of the state to intervene encourages rent-seeking activities that undermine private entrepreneurship. Rent-seeking activities are likely to be rampant when the state is potent but prone to the influence of private interests due to weak institutional constraints (Lin 2009). Rent seeking occurs not because of a lack of laws and regulations, but because laws and regulations are not institutionalized and can be applied in a discretionary way by the authorities (Schneider 2002).

Baumol (1990) has demonstrated that entrepreneurship can be directed to productive or unproductive activities. When more entrepreneurship is directed toward unproductive activities, such as rent seeking, less entrepreneurship will be available for productive activities, such as starting new businesses. Whether entrepreneurship is directed toward productive or unproductive activities depends on the reward system in the society. Widespread corruption indicates that rent seeking yields good returns in a society. In the same vein, Murphy, Shleifer, and Vishny (1990) have argued that when more of a nation's talent is allocated to distributive functions, such as rent-seeking-oriented

regulations, less talent will be devoted to creative functions, thus impeding the nation's growth potential.

According to the above theoretical assertions, we should not expect private entrepreneurship to thrive in China given its weak institutions. For example, institutions for property rights protection and investor protection are apparently inadequate (Allen, Qian, and Qian 2005). Although privately owned business firms have already been recognized by the PRC Constitution, state expropriation of privately owned firms remains a real risk (Hsia 2007). Market entry is strictly regulated in certain industries to protect established firms (Djankov et al. 2002). Contract enforcement remains difficult in general (Kwock, James, and Tsui 2013). The weaknesses in property rights protection and contract enforcement not only discourage risk-taking business ventures, but also prompt the investors to seek political connections (Li et al. 2008), which nurture rent-seeking behavior.

Economic growth is still possible under weak institutions if a strong state has sufficient capacity to chart the course of economic growth by coordinating private actions (Wade 1990). However, state-led growth is normally not conducive to private entrepreneurship, although the bureaucrats themselves may act like entrepreneurs as in the case of China (Oi 1995, Chen 2016). Baumol, Litan, and Shramm (2007) classified capitalism into four kinds: state-led, oligarchic, big firm-led, and entrepreneurial. The taxonomy depends on who dictates the resource allocation in the economy. China could easily fall into the category of state-led capitalism, in which the state rather than private entrepreneurs dictates the allocation of resources. There are observations that, in recent years, state and state-controlled enterprises have advanced their power in allocating resources at the expense of private firms (*guo jin min tui*) (Adams 2011). Huang (2008) has demonstrated that in the post-1978 Chinese economic development course, when the state increased its power in resource allocation, private entrepreneurship receded. With a similar argument, Wu and Huang (2008) portrayed a see-saw game between rent-seeking and innovative activities in the process of China's economic reforms. When the market was given more power in allocating resources, innovative activities were promoted and rent-seeking activities suppressed. Conversely, when the government, or its proxy, was given more power in allocating resources, rent seeking was fueled

at the expense of innovative activities. The boom in Internet startups in recent years appears to be a counter-example of this line of argument, and thus explanations are called for.

Weak Institutions and Strong Organizations

We argue that Internet startups thrive in China because of weak institutions coupled with strong organizations. Weak institutions allow strong organizations in the Internet sector to establish their own rules that encourage private entrepreneurship but also protect state interests, especially the interests of local government in the real sector. A delicate balance is struck between the state-led real sector and a market-led Internet sector. The balance is possible because the Chinese economy is half-open and half-closed. A half-open economy in the real sector allows Internet startups to leverage international institutions for development. International institutions enable access to foreign resources including financial, technological, and entrepreneurial resources. International institutions even extend property rights protection to local startups. A half-closed economy in the Internet sector creates national monopolies that provide a platform for the startups. The national monopolies act as agents of the state in regulating the Internet industry, but their profits have to come from the innovative activities of the startups that exploit the deficiencies in the real sector that is prone to rent seeking. The Internet sector is a shadow of the real economy. Rent seeking in the real economy creates distortions and hidden opportunities that nourish innovations in the Internet sector. This explains why rent seeking in the real sector promotes Internet startups. The platform operators have a strong incentive to maintain the state's power of rent seeking, because by doing so they also preserve the roots of profits. More distortions in the real sector imply more business opportunities in the Internet sector. Regulations originating from rent seeking often favor large producers at the expense of consumers (Stigler 1971). In response to this, the platform operators create an Internet environment that serves small producers and consumers.

In the following, we shall discuss some important features of Chinese (weak) institutions that significantly affect the behavior of business firms. These institutions fuel rent seeking and impede entrepreneurial activities in the real sector, but the institutional weaknesses are overcome in the Internet sector with the structures provided by

the platform operators and others. As a result, the Internet sector becomes a complement to the real sector deficiencies.

Foreign Investment Regime

China has offered favorable conditions to foreign direct investment since the early 1990s. Foreign companies bring new products and technologies to China, which may inspire indigenous innovations. However, favorable conditions afforded to foreign-invested companies may have crowded out the business opportunities of domestic enterprises (Huang 2008). Contrary to the favorable policy toward foreign investment in the real sector, multinational firms are almost completely blocked out in the Internet sector due to the concerns of national security. Aghion and Griffith (2005) have argued that trade protection may encourage rather than impede innovation if it enhances the potential value of innovation. The Chinese experience indicates that trade protection of the Internet industry has indeed encouraged innovations because innovation is the only way to enter the Internet markets, which never existed before. However, the innovation may have originated from imitating foreign products or business models. The imitation of foreign business models is especially visible in the Chinese Internet sector. Copy to China (a homonym of C2C) with modifications to fit the Chinese trading habits and business environment appears to be a quick success formula. Trade protection has produced a few monopolies in the Chinese Internet industry, all of which are privately owned. National monopolies impose self-regulation in order to prevent government interventions. Whereas the primary interest of the central government in the Internet sector is political—namely, maintaining the order of trade and controlling public opinion—the primary interest of the local government is economic. The platform operators impose private regulations to serve the central government interests on the one hand, and adopt business models that protect the local government interests on the other. By doing so, they create a free space for startups that fuels the rapid growth of the Internet sector, thereby justifying their legitimacy as national champions (Nolan 2001).

Insecure Property Rights

The risk of state predation on private properties remains imminent in China. For example, the cases of private businesses being

nationalized continue to exist. Even publicly listed companies are not completely immune from the risk of nationalization.¹ Building political connections is thus a popular way for business enterprises to hedge against state expropriation (Kung and Ma 2014, Duan and Chik 2012). Since profitable and growing companies are subject to higher risks of state predation than nonprofitable and stagnant ones, because the former command more rents to be extracted by the state, a good strategy for the owner-entrepreneur of a startup is to build a business venture as quickly as possible, making it profitable (or seemingly profitable) and getting it listed on the stock exchange or acquired by established companies. Upon the IPO or acquisition, the entrepreneur relinquishes (or dilutes) the ownership and realizes the entrepreneurial gains. In other words, insecure property rights prompt the startup founders to create business ventures without the intention of owning or managing them on a long-term basis. This strategy fits perfectly with the VC model, and it works especially well when foreign-based venture capital is involved as the latter facilitates overseas IPOs. State predation is unlikely to occur before an IPO. In addition to avoiding state expropriation, the Chinese Internet ecosystem works well to protect the property rights of Internet innovators as the value of an innovation can only be realized through the platforms owned by the national monopolies. Founders of the startups are entrepreneurs who sense the business opportunities and are willing to take action to realize such opportunities (Kirzner 1979). Platform operators serve as gatekeepers of their property rights. Platform operators also operate their own VC funds and angel funds that can be used to invest in and acquire promising startups.

Market Entry Barriers

It is not easy to start a private business in China. The World Bank (2015) ranked China 128th out of 189 countries surveyed in terms of the ease of starting a business. The ranking is measured by the number of days needed to complete a business registration. In fact, in

¹For example, two listed semiconductor companies on the NASDAQ, Spreadtrum and RDK, were recently acquired by a state-backed fund and delisted to become companies under state control.

addition to business registration, various licenses may be required before a business can be operated legally. As an indication of the difficulty in obtaining a license, the World Bank ranked China, in a separate category of the same survey, 179th out of 189 countries in terms of the time needed to obtain a construction permit. Most licensing controls are in the hands of local governments that typically prefer large businesses over small ones. Local governments would rather provide incentives to attract subsidiaries of large, established companies, whether domestic or foreign, instead of helping startups or small and medium-sized enterprises (SMEs), because the former are more effective in terms of quickly increasing the production base in their jurisdictions. They expend more resources on attracting investments from outside the regions (including foreign countries) than on incubating startups within their territories. Therefore, no help is provided in starting a private business in China, especially in rich cities that are resourceful in subsidizing outside investors. In contrast to the hassles in the real sector, starting an Internet business avoids all the troubles associated with licensing controls. All that is needed is an Internet business registration, which can be expedited through the platform operators. A business registration can even be avoided in the case of C2C trade. Once the company starts selling its products or services on the Internet, the platform operators provide an umbrella of business licenses. The platform operators welcome new products and services to enhance the value of the platforms. Most importantly, there is no need for Internet startups to acquire a piece of land, which is owned by the government and is the bastion of rent seeking. While an Internet business is a landless operation, its success may contribute to the demand for land, such as transportation and logistics operations derived from online trade, to benefit the land owners, namely, the state. In fact, the booming Internet startups in recent years have created a demand for incubation bases in urban areas, giving the local government a new outlet for land development.

Land-Based Fiscal Policy

Land is owned and disposed of by the local government in China, and land has become an important source of fiscal revenue for local governments since the tax reform in 1994 (Yang 2012). Local governments allocate land usage in a way that the land's value is maximized. For example, local governments prefer land users that build high-rise

office buildings and luxurious shopping malls rather than road-side stores. Even in allocating land use to road-side stores, local governments prefer renowned international brands over little-known local brands (Huang 2008). Local governments control the number of department stores or hypermarts in order to create monopoly rents that can then be captured by land value. This practice makes the entry charges for retail channels extremely high in Chinese cities. In other countries, this would give rise to booming road-side vendors or other forms of underground economy. However, Chinese city governments often deploy semi-police forces, or *cheng-guan*, to eliminate road-side vending activities. Against this backdrop, the Internet provides a sanctuary for small brands or counterfeits in China that would have presented themselves in underground trade in other countries. Local governments are happy to see the would-be road-side vendors retreat from the streets instead of competing with their patrons. Better yet, they can be regulated through the platform operators. In essence, the Chinese Internet economy is a special zone that keeps the underground economy at bay. Private regulations are imposed by platform operators to harness Internet trade just like the informal institutions that regulate the underground economy in other countries. The only difference is that these private regulations are subject to the ultimate control of the state and they always serve state interests, whereas informal institutions are out of the hands of the government. Reconciliation of business interests with state interests through private regulations is pivotal to the stability of the Chinese Internet industry.

Local Protectionism

Local protectionism has its origins in the dual-track price system and fiscal decentralization in the early stage of the economic reforms in China (Wedeman 2003). Despite the fact that the dual-price system has now been eliminated and that fiscal power is more centralized than in the past, local protectionism lingers on. Local protectionism is likely to occur in the industries that generate good tax revenues or business earnings for local governments, and in regions where state ownership is high (Bai et al. 2004). Local protectionism produces a segmented market, which limits industrial specialization and precludes the benefits of scale economies of a single market (Young 2000). It also produces local monopolies whose interests are aligned with local government interests. While

the central government does not like local protectionism, local government officials continue to embrace it because their prospects for promotion are linked to local economic performance (Li and Zhou 2005). Internet trade is a natural enemy of local protectionism as it spans regional boundaries and exploits the price differences between regions. The platform operators have to unite with the central government to deter interventions by local governments. They also have to refrain from entering businesses in which vested local interests lie and, if possible, they will form alliances with local monopolies. This strategy has worked well. In May 2015, the State Council of the central government issued an ordinance (no. 24), “Promoting E-Commerce as a New Economic Force” (*guanyu dali fazhan dianzi shangwu jiakuai peiyu jingji xin dongle de tongzhi*), instructing local governments to reduce regulatory controls on Internet trade. The ordinance advises the local governments to issue business licenses to Internet stores before any field-specific approvals are to be processed (*xian zhao hou zheng*).

Case Studies

In this section, we will study the cases of Chinese Internet startups that are listed as Dow Jones Venture Source’s 2015 one-billion dollar startups to elucidate the following propositions: (1) Internet innovations are inspired by the opportunities arising from the distortions caused by rent seeking in the real sector, and (2) rules imposed by the platform operators and business models followed by the Internet startups reinforce rather than weaken the power of the state. The cases will be grouped into three categories: taxi app, Internet retailing, and O2O services.

Taxi App

As urban populations have grown, the demand for taxi services has increased. In most Chinese cities, taxicabs are operated by a limited number of licensed companies, many of which are owned by the city government or state enterprises. In many large cities, taxi licenses are frozen despite the population growth because of concerns over traffic congestion. Normally, since individual licenses are not granted, a taxi driver is required to be affiliated with a taxi company to become a qualified taxi operator. The taxi company leases the taxicabs to

drivers and the leasing fee goes by month or day. Because of controls over licensing, the leasing fees are high, and taxi drivers have to use the cabs as efficiently as they can to make a living. They consciously avoid the destinations that will result in empty cars on the return trip or will force them to enter the congested traffic zones. The drivers are particularly choosy during the rush hour or when they are approaching the deadline of their shift. Difficulty in obtaining taxi services is a common headache for travelers in Chinese cities. By controlling taxi licenses, the local government benefits directly from the inflated leasing fees charged by the state-owned taxi companies or indirectly from the rent-seeking activities of private companies. Local governments can also use the purchasing power of the taxi fleet as an industrial policy tool to support the local automobile manufacturers. In response to the taxicab shortages, unlicensed taxicabs (black cabs) have emerged in Chinese cities, particularly during the rush hour. Against this backdrop, many taxi apps started to emerge after 2012, probably inspired by the successful model of Uber in the United States. Among them, Didi Dache and Kuaidi Dache are the largest ones.

Founded in 2012, Didi Dache is an Internet startup providing a mobile app which matches taxicabs with the riders. When a rider requests a taxi service on the mobile phone, cab drivers within a certain distance of the call will receive the request signal and they can offer to deliver the service simply by responding to the request, and a match is completed. If no response is made by any cab driver, say, because the trip is too short to attract a deal, the rider can offer a premium on top of the meter price. The system operator may also jump in to offer a subsidy if the riders have waited a long time. Because of the price flexibility, the Didi Dache app has claimed a matching rate exceeding 90 percent. Tencent, one of the largest Internet platforms in China, soon found the potential of the app and invested in the startup venture. Other VCs, both domestic and foreign, joined the investment in later rounds of fund raising. In an attempt to build up its user network, Didi Dache offered subsidies to both drivers and riders in matched transactions, and provided a bonus credit for new users. Tencent also applied its mobile payment facilities to enable online payments to be made for the taxi ride. Online settlement saves the trouble of cash transactions and makes subsidies (or commission charges) easy to execute.

The business model of Didi Dache was soon imitated by Kuaidi Dache, which was founded one year later in 2013 and subsequently

invested in by Alibaba, the archrival of Tencent. Didi and Kuaidi then engaged in a subsidy war and eventually drove out all the other competitors. According to Didi's own account, by the end of 2014, it had more than 100 million registered riders, and more than one million registered taxicabs, covering more than 300 cities, with daily matches exceeding 5.2 million trips (Wu and Piao 2014). Kuaidi was about the same size. Despite the huge numbers of members, both startups are still losing money today. Nevertheless, both of them have already attracted several rounds of investment from VC funds, with a total market value exceeding one billion U.S. dollars each.

The app services offered by Didi and Kuaidi have increased the revenues of taxi drivers without hurting the profit base of the taxi companies.² The service is also welcomed by local governments whose interests are tied to local taxi companies, because the app, which is offered only to licensed drivers, narrows the operating room of black cabs. It also improves the safety of taxi riding as both drivers and riders are registered users and all rides are tracked throughout the trip. However, when Didi started to offer rental car services to corporate customers, many local governments opposed the move.

Although Didi was started by an individual entrepreneur who made the initial innovation or imitation, the strategy of the company was shaped by its major investor, Tencent. Its competition with Kuaidi is tantamount to a competition between two Internet platforms. The rules that the platform operators have established are often complementary to government regulations. For example, if a taxi driver fails to carry out the matched deal for the first time, the driver's account will be suspended for three days. A one-month suspension will be imposed for a second-time violation, and the account will be removed permanently for a third-time violation. These rules are imposed on the basis of a private contract. Complaints about the taxi services or riders are easy to convey on the mobile Internet, so malicious drivers or riders can be disciplined. The riders are allowed to rate the service quality of the taxi, which affects the subsidy offered to or commission levied on the driver. The Chinese Internet platform

² In a few cities where private cars have been allowed to offer taxi services by adopting the Didi Dache app, such as Shenzhen where Tencent is headquartered, the profits of taxi companies have been hurt and a regulation is being deliberated to protect the interests of taxi service providers.

operators are willing to impose self-regulation because they are conscious of the risk of government intervention. Didi is even collaborating with the city government of Shanghai to track down black cabs and clone (falsely licensed) cabs in the city.

Internet Retailing

Along with economic growth, modern shopping facilities, such as department stores, shopping malls, or chain stores, have mushroomed in the Chinese cities. Leasing land to commercial developers is an important source of fiscal revenue for local governments. Local governments prefer large corporatized retailers to small individual- or family-owned stores (Wang and Song 2008). The Chinese retail industry is fragmented and characterized by high entry barriers. Compared to developed countries, retail space in urban areas in China is in relatively short supply. Chin and Chow (2012) reported that retail space per capita in China was only 12.9 square feet, which was much lower than the 45.2 square feet in the United States or the 16.4 square feet in Japan despite the high population density in Chinese cities. A shortage of retail space and the concentration of modern shopping facilities in city centers translates into high rental costs that screen out small vendors. Even for street stores, local governments may prefer big brands to small ones as lessees of state-owned property in order to enhance the land value. Huang (2008) reported that the Shanghai city government, in an effort to inflate the land price, chased small local brands out of the prestigious Huaihai Street, the most popular shopping district in the city, in favor of foreign brands. Because owning shopping space is such a privilege, it is a typical practice in the Chinese retail industry for channel owners to only rent out space to brand vendors without purchasing the commodities. Channel owners typically charge multiple fees to vendors, including a store entry fee, shelf-display fee, promotion fee, advertisement fee, etc. New charges can be added to the list at any time (Zhen 2007: 166–67). The brand vendors bear the inventory costs and the marketing responsibilities. This structure makes it very difficult for small local brands to enter the modern shopping facilities, not to mention the startups. Unlike in other developing countries, road-side vending is not a viable alternative in China because of strict government regulations and interference.

Shopping online has provided an alternative to shopping in physical stores. China has developed one of the largest online retail

industries in the world. The volume of online shopping exceeded 10 trillion RMB in 2014, the largest in the world. Most Chinese online shoppers use the Internet as an alternative to physical stores instead of purchasing genuine online products that are unavailable offline, such as games or online services. McKinsey Global Institute (2013) reported that 61 percent of Chinese consumers who shop online treat the Internet as a substitute for physical store purchases. This suggests that the high costs in physical stores have fueled the growth of Chinese online business. Small brands or unbranded products see the Internet as an alternative marketing channel for which the entry charge is low and predictable. Therefore, unlike in Western countries where electronics products dominate Internet shopping, the top selling product on the Chinese Internet is clothing, which is normally more conveniently sold in physical stores as an experience product. The most successful Chinese online brand for apparel products, VANCL, allows consumers to try on the clothes upon delivery without an obligation to buy. Even after the purchase, the consumers can still return the products within 30 days without explanation. This arrangement essentially allows consumers to experience the products after delivery.

The leading e-commerce platforms, such as Alibaba's Taobao (primarily C2C) and Tmall (primarily B2C), provides virtually free entry for retail vendors. Alibaba makes money by providing delivery and payment services, in addition to advertisements. Alibaba has built one of the most efficient logistics networks across the nation. The logistics services in China are segmented because of locally erected trade barriers and heterogeneous local regulations. No logistics operator holds a nationwide service network except China Post, which is state owned and notoriously inefficient. Alibaba extensively made use of the storage and transportation facilities in different locations, instead of establishing its own facilities. It works with many logistics service providers, including China Post, to construct a nationwide network. The shoppers can choose their preferred logistics service providers when purchasing. Alibaba only combines the capabilities of different logistics companies in different locations and standardizes the service procedures. Alibaba has claimed that more than one million small logistics operators have worked for its parcel delivery service, which accounted for two-thirds of the nation's total (Inside 2013). According to a central government regulation, all parcel service providers have to obtain a license from China Post. With the rise

of online shopping, the parcel service industry has boomed throughout the country but has also remained segmented and locally embedded. Alibaba is an integrator of local service networks without intruding into the vested interests of local operators, many of whom are tied to the local government interests.

Partly owing to local protectionism, the Chinese retail industry is fragmented despite the proliferation of retail chains that transcend provincial borders. In 2013, the top 100 retail chains in China accounted for only 9 percent of retail sales (Statista 2015). Two top retailers, Suning and Gome, both of which have specialized in consumer electronics products, have built nationwide channels to break down local barriers. Four leading foreign retail chains, RT-Mart, Wal-Mart, Lotus, and Yum, have all specialized in grocery and food products (Table 2). Domestic retailers making the top-10 list are all affiliated with local states, except for Gome, which is privately owned. Online-shopping giants such as Alibaba, which dominates the Internet trade with a more than 50 percent market share, present little threat to retail chains owned by local states as Alibaba offers a platform primarily for small brands, while the state-owned retail channels host big-name products. For example, in the offline market for clothing, foreign brands such as Uniqlo, Zara, and H&M have relied on department stores and specialty stores for marketing,

TABLE 2
LEADING RETAIL CHAIN OPERATORS IN CHINA, 2013

| Name | Sales (billion RMB) |
|---------------------------------|---------------------|
| Sunning Commerce Group | 138.0 |
| Gome Electrical Appliances | 133.3 |
| China Resource Vanguard | 100.4 |
| RT-Mart Shanghai | 80.7 |
| Wal-Mart (China) | 72.2 |
| Lianhua Supermarket (Lotus) | 68.8 |
| Shandong Commercial Group | 61.1 |
| Shanghai Friendship Group | 60.8 |
| Chongqing General Trading Group | 60.3 |
| Yum! Brands Inc. (China) | 50.2 |

SOURCE: Statista (2015).

whereas small local brands have relied on street stores, supermarkets, or hyper-marts as outlets. As of 2013, department stores and specialty stores dominated the retail sales of clothing with market shares of 36.3 percent and 29.7 percent, respectively (Lu 2014). The department stores and specialty stores, which are normally located in city centers, are closely tied to the interests of local government through land-leasing contracts or direct ownership. The rise of online shopping has forged an alliance between small brands and Internet portals, which present more of a threat to street stores, supermarkets and hyper-marts than to department stores and specialty stores.³

O2O Business

O2O is a more recent business model on the Internet, which allows consumers to purchase services online while consuming the services offline. It may apply to services such as restaurants, movies, fitness clubs, tourism, and the like, which cannot be packed and sent to consumers in the form of parcels. O2O operators offer services like matching, payment collection, discount promotion (vouchers), or group purchases. They create value that resembles an agglomeration effect in the real sector by putting together a group of service providers in the Internet space for consumers to choose from. Along with the provision of information, the O2O operators also offer a location directory, store ratings, and so on to consumers and undertake product promotion campaigns for service providers. In essence, O2O facilitates trade by reducing information asymmetry. The largest O2O operator in China, Dazhong Dianping, boasts 200 million registered users on its website and 14 million service providers located in 2,500 cities. However, all services are local. The users can choose only from a list of service providers in a certain location where their consumption is to take place. Therefore O2O is a good technical tool to promote consumption in a specific location, serving the interests of the local government.

³Conflicts with local interests are more likely to arise if online shopping is modeled as a simple substitute for offline transactions. For example, the second largest online shop in China, JD.Com, adopts a business model similar to Amazon as a reseller rather than a platform, and consumer electronics is its major item of sales. It competes directly with the major retail chains of consumer electronics, notably Suning and Gome, which also hold online marketing divisions to parallel their offline operations.

The service industry has long been overlooked in the course of economic development in China. Until recently, China's industrial policy had consistently been in favor of the manufacturing industry. Services, especially consumer services were largely ignored or even discriminated against by local officials. Compared to other industries, it is relatively difficult for consumer service providers to access land or finance, or to obtain business licenses as they are considered low-tech and add little value to the land. However, that policy stance has changed in recent years as manufacturing-led growth has slowed. As a manifestation of the policy change, the central government called for the promotion of "high-value" consumer services in the 12th Economic Plan (covering 2011–15).

The relatively underdeveloped Chinese service industry can be explained by a lack of marketization (division of labor), a lack of innovation, and inadequate demand from consumers (Cheng 2013). It is partially caused by strict regulations in certain service sectors such as education and medical services. Although the share of service expenditure in consumer demand has increased in recent years, the increase has mainly been accounted for by an increase in the price of services rather than quantity (Cheng and Blanchard 2009). This has occurred because the demand for education and medical services is inelastic, a reflection of the Baumol disease (Baumol and Bowen 1966). As consumers have been forced to spend a larger share of their income on such services, they have become increasingly sensitive to the prices of other consumer services and the O2O app has become a handy tool to help them make smart shopping decisions.

Most successful Chinese O2O operators focus on modern consumer services such as restaurants, movies, tourism, and fitness clubs, for which the demand tends to rise with personal income. The O2O services target young consumers, or the so-called post-1980 and post-1990 cohorts residing in urban areas. This group of consumers depends on mobile devices for information collection and exchange. Therefore, the O2O business is essentially a mobile business where the service providers help the sellers disseminate information (e.g., in the case of new shop openings or excess capacity, or to explore new consumers). The established service providers are willing to collaborate with O2O operators as they see this as an expansion of their marketing channels, while new entrants use O2O channels to promote consumer awareness.

The development of the modern consumer services industry is in the interests of urban governments that are looking for a new growth engine where the manufacturing-centered growth model has imposed excessive environmental and population burdens on the cities. Modern consumer services that cater to the younger generation are often co-located with high-end retailers in modern shopping malls. In recent years, local governments have had a strong craze for shopping malls, which have become favorite investments for the purpose of land-value enhancement. For example, the real estate research firm CB Richard Ellis tracked new shopping mall construction in 2012 in 180 major cities around the world and found that more than half of the new malls under construction were in China (Rapoza 2013). Second-tier cities like Chengdu, Tianjin, and Shenyang top the list in terms of shopping mall investments. O2O services, which promote the offline consumption of modern services, also enhance the value of modern shopping complexes and are therefore welcomed by the local governments.

Making Peace with the State

The Chinese Internet industry has developed largely without government initiatives, such as policy guidance, financial subsidies, or tax incentives. The Internet industry is dominated by a few large firms, notably Baidu in search engines, Alibaba in online shopping, and Tencent in messaging and online games, which are together known as the BAT. The BAT has driven foreign competitors, including Google, Amazon, and eBay, out of China, thereby materializing the country's aspiration for national champions (Nolan 2001). Unlike in other industries in China where government intervention is prevalent, in the Internet industry government intervention is conspicuously absent either in terms of market entry restrictions or regulations on business operations. What, then, makes the Internet industry so different from the others?

The explanation lies with the existence of national champions in BAT, which act as policemen and rule makers in Chinese cyberspace. The BAT is a surrogate of the state in the enforcement of public regulations, including opinion controls, which top the list of government interests. The BAT offers domestic substitutes for search engines like Google, and social media like Facebook, Line, and Twitter, allowing the government to control and monitor information dissemination on

the Internet. While performing these important social functions for the state, the BAT exploits its monopoly power over the Internet for business benefits. As traffic is the king in Internet competition, three BAT firms compete with one another in amassing large numbers of users, and offer new products and services through innovation to do so. To maximize the number of users, the BAT firms position themselves as platform operators rather than store owners. They create public goods to fuel the industry growth and establish rules to maintain orderly trade on the Internet. They follow the policy winds closely and always act before the government to foreclose possible intervention. When disputes arise with the government, they compromise to preserve their core business interests. Although such compromise often constitutes a barrier to business expansion, they innovate in order to break through the barrier. In fact, innovation under institutional constraints has been the engine of growth in the Chinese Internet industry.

With this “peace making” strategy, the central government has until now imposed only a few regulations on the Internet industry. In fact, there is no basic law in China that governs Internet transactions such as electronic signatures or electronic money transfers. Piecemeal regulations have been introduced by some local states that are interested in developing the Internet industry in their regions. For example, Guangdong Province issued an e-commerce protocol (*Guangdong sheng dianzi shangwu tiaoli*) in 2004, giving electronic documents the same legal status as written documents. Zhejiang Province issued an ordinance on e-commerce (*dali tuidong wangshang shichang kuaisu jiankang fazhan de ruogan yijian*) in 2008, instructing the subprovincial government agents to lower the entry barriers to e-commerce, including making offline business registration automatically valid for online trade. It is no coincidence that Guangdong and Zhejiang respectively host two members of the BAT, namely, Tencent and Alibaba.

It is not unusual for industry-leading firms to impose self-regulation in order to avoid government regulations, to differentiate themselves from their peers, or to enhance the legitimacy of private firms (Haufler 2001). Self-regulation is often imposed to protect public interests, such as the environment or labor rights, which are vulnerable to private abuse because of inadequate public regulations. The reason why the government does not impose sufficient regulations is often because of the conflict of interests between different

parties that wield political influence. Private regulators have the discretion to side with particular interest groups, and it is desirable to do so if this stance creates a competitive edge in business-to-business or business-to-consumer relations (Sorsa 2010). The competitive edge enhances the profitability and survival of self-regulated firms.

Self-imposed rules of the BAT are often directed toward the consumers whose interests in offline trade are inadequately protected under the government regulations. The BAT sets liberal return policies, subsidizes consumers from time to time, gives an upper hand to consumers in the case of a dispute, and allows consumers to choose their own logistics service providers when shopping, and to rate the quality of service to determine the service price, and so on. On the other hand, vendors or service providers are obliged to cooperate with the platform operators in promotion campaigns and will be disciplined for unethical behavior. Siding with consumers enhances consumer loyalty. The rules are aimed at boosting the Internet traffic that ultimately determines the outcome of Internet competition. The rules therefore serve the BAT's own interests. The government may be forced to endorse the private rules if they have become industry standards. Indeed, the BAT's return policy had been practiced long before the Chinese government amended the Consumer Rights Protection Law in 2014 which mandated all retailers to accept product returns within seven days of the purchase, and Internet retailers have to do so without asking for reasons. The case suggests that private regulations, if successful, may define the course of public regulations.

Private regulations may also preempt government regulations by making them unnecessary. This happens when private regulations incur lower costs than government regulations. Rules that enforce online trading contracts are primary examples. National monopolies like the BAT can enforce trading contracts more effectively than the government because they have better information about the traders, and because they control the payment mechanisms. They also control market entry and may discipline violators without administrative or court procedures. In order to maintain trading order, it is actually more effective for the government to control a few platform operators like BAT than millions of small traders. For example, the city of Hangzhou, where Alibaba is headquartered, issued an ordinance on Internet transactions in March 2008 (*Hangzhou shi wanglu jiaoyi guanli zanxing banfa*), requiring all online stores to operate on a

third-party platform instead of establishing their own portals. The platform operators bear the responsibilities of examining product authenticity, conducting credit assessments of traders, and preventing malicious competition or unwarranted disturbances of consumers by vendors through the Internet.

Private regulations, while serving the public interest, may also constitute an entry barrier for latecomers (Curran 1993), thus protecting the market position of leading firms. For example, by setting up consumer-biased trading rules and amassing a large consumer base, it is hard for latecomers to compete with a smaller consumer base. Scale is a natural barrier to entry for Internet businesses. With a large consumer base at hand, vendors have either to go along with the existing rules set by BAT or to establish their own portals if they are to enter online trade. Large vendors and famous brands may choose the latter option, but they will not become platform operators to rival the BAT. In other words, private regulations as such serve the purpose of market differentiation. The BAT has targeted small vendors as the main customers and has consciously avoided competing with large vendors whose interests are likely to be tied to the state.

However, it is also possible that private regulations serve the public interest only superficially. An organization's compliance with government regulations or social norms may only be ceremonial thereby entailing resource costs without real effects. Chinese consumers have often complained about the rampant counterfeit products in online trade, and the SAIC regulations require that the platform operators enter a contract with the vendors so that the latter are held liable for the counterfeits. In reality, however, no private contracts may actually ensure the authenticity of the products. The platform operators of the BAT simply impose a liberal return policy to ease the grievances of consumers if they are unhappy with the products. In other words, consumers are asked to decide whether the products are authentic or not. In January 2015, SAIC issued a report (*guanyu dui Alibaba jituan jinxing xingzheng zhidao gongzuo qingxing baipishu*), indicating that only 36.25 percent of products sold on Taobao (of Alibaba) are authentic, but no actions were taken to penalize Alibaba. Legally, it is the vendors that are liable for the counterfeits, not the platform operators, who only cooperate with the authorities in law enforcement. The extent of cooperation is negotiable, and the SAIC report appeared to be a bargaining ploy. In fact, Internet trade offers more policy tools for the government to control counterfeits if the

issue is really taken seriously. Alibaba has organized a 700-member counterfeit-fighting task force which polices the platform to spot and remove counterfeits. A formal structure is a convenient tool that serves the ceremonial purpose of compliance to social norms or public regulations to earn legitimacy for the organization (Meyer and Rowan 1977).

In short, private regulations imposed by the BAT have set the standards for public regulation, have made the public regulations redundant, and have differentiated the BAT from its peers. All these serve the business interests of self-regulators and solidify their monopoly position. On the other hand, the BAT's compliance with public regulations is selective. In areas where state interests are non-challengeable, such as controlling public opinion, they comply with good efforts. In areas where the compliance cost is high, they conform to the regulations by structures rather than actions.

In addition to rule making, the BAT also creates public goods for the Internet industry. The most important public goods created by the BAT are online payment facilities, such as Alipay, which offer third-party escrow accounts to enable transactions. The third-party accounts protect consumer interests and guarantee payments to vendors at the same time. Alipay may have been an imitation after PayPal of the United States, but its success was possible only with Alibaba's long-term investment which gradually built up the public confidence in the mechanism. In 2010, six years after the inauguration of Alipay and many subsequent mimics, the central bank, People's Bank of China (PBOC), decided to regulate third-party payment accounts such as Alipay. The PBOC required account operators to obtain a license from the PBOC and to deposit their balances in commercial banks.⁴ This allowed the banks to share the benefits of online trade without having to offer online accounts to Internet shoppers or vendors for whom the service costs might have been uneconomical because of the difficulty in performing credit assessments on them. As a result, third-party payment account operators like Alipay now work as deposit collectors for the commercial banks, which are mostly state-owned. Commercial banks make money mainly from the interest rate spreads between deposits and loans; fees charged on

⁴As of July 2013, the PBOC had issued 250 licenses for third-party payment accounts.

payment collections like credit cards constitute only a small fraction of bank earnings.

The separation between third-party payment accounts and bank accounts was apparently a compromise between the state and the BAT. While requiring third-party payment account balances to be deposited in commercial banks, the PBOC did not stop the BAT from offering short-term credit to Internet traders. By doing so, Alipay and its counterpart of Tencent, Weixin, have become giant microfinancing organizations that service Internet traders. Traders' balances in the online payment accounts bear interest, and while this is at a rate that is lower than the bank rate, the balances can be applied to online and offline purchases at any time. As more and more offline shops have accepted Alipay and Weixin for payments, they have become China's dominant mobile payment instruments, foreclosing the business chances of foreign competitors like Apple Pay or Google Pay. Initially Alipay and Weixin were invented to facilitate online payments to supplant the institutional weakness arising from the lack of credit cards in circulation in China. In the end, these instruments work like interest-bearing debit cards in offline transactions. Today, the PBOC still prohibits the BAT from issuing online credit cards, which are reserved for commercial banks to defend the latter's interests.

As more and more traders hold Alipay or Weixin accounts, these payment mechanisms have become true public goods. Individual account holders can use these accounts to send gifts or make unilateral transfers without engaging in trade. C2C traders can also enact a transfer of funds from the buyer's account to the seller's without going through the platform's trading portals, thus avoiding the entry fees or commission charges. In other words, they can engage in an "underground" transaction by leveraging the online payment facilities. Public goods cannot avoid free-riding, which has been tolerated by the BAT. Some scholars argue that China now tops the world in Internet finance in terms of the volume of transactions or diversity of financing arrangements (Ma et al. 2014: 14). Many innovations in Internet finance have been precipitated by the weaknesses of the banking industry, including a lack of credit cards, an inability to perform credit assessments, credit rationing, and so on. Unlike shadow banking activities that threaten the stability of the banking system in China, Internet financing benefits the banking system by enlarging the deposit base of the commercial banks. Small young traders, who

are normally outsiders to the banking system because of a lack of creditworthiness, are now engaged in the system through Internet finance. Better still, all financial transactions take place before the eyes of the regulatory authorities, who may choose to intervene at any time.

Conclusion

The Chinese economy is half-open and half-closed. The real sector is open to both foreign trade and foreign investment. However, domestic business activities are heavily regulated, giving rise to rent-seeking behavior. Rent is created through the government ownership of land and licensing controls on business activities. Rent seeking is accompanied by high entry barriers, which suppress domestic entrepreneurship. On the contrary, the Internet sector is closed to foreign operators in favor of domestic monopolies, who offer a platform for entrepreneurial activities. Through innovations, Internet entrepreneurs uncover the market opportunities hidden behind the distortions created by rent seekers in the real sector.

All Internet innovations seem to have one common thread, which is to remedy the deficiencies of the real-sector economy. Notable Internet innovations include those that explore new market frontiers, reduce transaction costs, exploit scale economies, eliminate information asymmetry, and so on. However, none of these innovations have engendered a destructive effect on the real-sector economy as the government, or its proxy, always controls complementary assets for the realization of Internet innovations. With these complementary assets, it gains rather than loses from Internet innovations. This explains why the government has, until now, kept its hands off the Internet industry.

The Internet creates a new platform for trading which is characterized by virtually free market entry and low transaction costs. Internet trade in China constitutes an economic sector that is analogous to the underground economy in other developing countries. However, unlike an underground (informal) economy that survives by evading taxes and circumventing government regulations, the Chinese Internet sector is taxed and regulated. To the extent that Internet trade is subject to the same tax and regulatory burdens, it reduces the threat to the formal sector, and preserves the opportunity for rent creation by the local government. The Internet sector

sustains itself by low entry and low transaction costs, and therefore represents a true free-market economy in China.

Like the informal sector in other countries, the Chinese Internet sector is separated from the formal sector in terms of products offered and factors employed. Internet products are relatively unknown brands characterized by small-scale production, whereas the real sector favors large vendors and famous brands. The Internet sector employs its own resources for branding, manufacturing, marketing, financing, transportation, and after-sales services that are distinct from the resources used in the real-sector production. Differences in product and factor prices between the real and Internet sectors persist and are not to be arbitrated.

Similar to the informal sector which is subject to the rules of informal institutions, the Chinese Internet sector is regulated by rules established by the platform operators. The platform operators have a strong incentive to self-regulate to avoid government intervention. They are conscious of the central government priorities such as controlling public opinion and maintaining trade order. Platform operators also create public goods to facilitate online trade, which is otherwise infeasible under the real-sector institutions, like payment mechanisms and microfinancing. Self-regulation and public goods serve the public interest as well as the platform operators. The Chinese Internet is therefore a case of strong organizations coupled with weak institutions. While strong organizations are necessary to make up for the weaknesses of institutions, strong organizations cannot survive without state patronage. This structure underscores the stable relationship between the Internet operators and the state.

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