From Relations to Rules: A Theoretical Explanation and Empirical Evidence

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Chapter 10
From Relations to Rules: A Theoretical Explanation and Empirical Evidence

Shaomin Li

INTRODUCTION

There is a general perception that people in the East rely more on guanxi (relations, or informal social networks) to govern economic transactions and manage business activities than people in the West. A large quantity of literature on the difference has been produced. One of the dominant views argues that the difference is due to culture, which is treated as an exogenous variable. These studies on culture as the determinant of different management and governance style have helped us gain insight on how businesses are conducted in different regions of the world and on how cultures differ throughout the world. However, attributing the differences in management style and in the mode of business governance primarily to culture does not add to our knowledge on why certain culture prevails in a particular country or region in the first place to shape the management style and the mode of governance, how management styles evolve, and how different management styles and modes of governance interface.

A new perspective in examining the role and evolution of guanxi is the theory of rule-based and relation-based governances proposed by Li, Li and Li, The Economist, and Li and Park. In this chapter, I will first discuss the evolution of relation-based governance using the theory of rule-based and relation-based governances, and then present historical and contemporary evidences to draw the conclusion that the East does not love guanxi more than the West; it only reflects a different stage of political and economic development.
The Scale of Market and the Mode of Governance

In their theory, Li and Li propose a dichotomy between two modes of economic governance in terms of information and enforcement that bears different cost structure: relation-based and rule-based. An effective way to understand these two modes is by comparison. As we mentioned earlier, the prevailing view is that the East uses relations while the West uses rules. What distinguishes economies in the East from the West is what we call “relation-based capitalism,” in which investment is largely shaped by relation-based governance, where most transactions are based on personal and implicit agreements, not on formal contracts that are enforceable by courts. The central feature of relation-based governance is that information is largely local and private, and thus cannot be verified by a third party. The relevant information of a partner regarding monitoring and enforcement may include (1) his history and reputation (“ex ante monitoring information”: if a man cheated his father, he can cheat anyone); (2) financial status and profit prospects (“interim monitoring information”); and (3) identity and assets (“ex post monitoring information”: in case of default, where to find the defaulter and to seize his assets or to kidnap him). In contrast, rule-based governance largely relies on public information, namely, publicly verifiable information.

When relation-based governance works, it can enforce all agreements that are mutually observable by the two parties. In contrast, rule-based governance can only enforce a subset of the agreements mutually observable by the two parties that can also be observed by a third party.

A rule-based governance system involves large fixed transaction costs, including costs of drafting, interpreting, and implementing contracts and corporate laws by the legislative, judiciary, and executive branches, respectively. However, the marginal costs of enforcing an additional contract between an additional transaction pair are negligible, because the institutional infrastructure has already been well established. Furthermore, only when the rules are fair, impartial, transparent, and efficient, can people rely on them instead of using private means (relations) to govern business transactions.

In order for the rule-based governance system to work effectively and efficiently, information at the microlevel, such as financial information, business transactions records, and firm-level operation data, must be highly accurate. This requires a well-established information infrastructure that consists of accounting, auditing, notary services, and legal codes and cases.

Unlike rule-based governance, relation-based governance requires only minimum public order (the absence of rampant robberies or confiscation). It is not necessary to have a fair, impartial, transparent, and efficient legal sys-
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In fact, it is precisely due to the lack of such a system that forces people to rely on relations to govern transactions. Establishing relationships involves few fixed costs, but significant marginal costs. In relation-based governance, one needs to develop and nurture a personal relation, which is time-consuming, and to screen, test, and monitor every transaction partner. The obtained relational information is implicit and individual-specific, and hence not publicly verifiable and nontransferable. Thus, the delegation of relation-based enforcement is virtually impossible, and the manager of a firm has to take care of all relations by himself (this is one of the reasons why in China many executives answer phone calls themselves instead of using secretaries). As business expands, one needs to deal with partners with increasing searching and monitoring costs, or to develop increasingly more costly relations. Thus there is bound to be diminishing returns to the manager’s effort to cultivate further relations due to the rising marginal costs of private monitoring. This is why the Asian wisdom is first do business with one’s siblings, then with one’s cousins, then with folks from hometown, or classmates, and finally—and reluctantly—with strangers.

Furthermore, for relation-based governance to work, accurate, publicly verifiable information at the microlevel, such as accounting and auditing information, is not necessary. In fact, it is the lack of such information that forces people to govern their business activities by relations rather than by rules.

When the size and scope of the market are small, or transaction partners are few, the average (transaction) cost in relation-based governance can be smaller than that in rule-based governance, since the former can avoid the large fixed transaction cost. But as the market expands from the local, regional, national, and to the international level, the number of business partners increases and the incremental costs of relations will eventually become extremely high.

For business transactions to take place, they must be enforced either by rule or by relation, or by some combination of both. The absence of both means chaos. In catching-up economies such as those of Asia, there is generally no rule-based governance; hence relation-based governance is the only available mechanism to enforce agreements. Thus, investing in relations can be profitable and rational.

Culture and the Mode of Governance

Our theory implies that the mode of governance is not primarily determined by culture, but by the stage of political and economic development. However, we recognize the important role of culture in shaping and affecting the mode of governance and its efficiency and effectiveness.
North’s theory of institutional change offers a framework to explain the role culture plays in influencing the mode of governance. According to North, institutions are the “humanly devised constraints that shape human interactions” in a society. These constraints structure incentives in social, economic, and political exchanges. Organizations and individuals are the participants in the social interaction who respond to the incentives and try to maximize their gains. Institutions fundamentally determine economic performance of a society through their incentive structure and their efficiency in lowering transaction costs. Differences in economic performance between countries are primarily due to the different paths in institutional changes over time.

North distinguishes two types of institutional constraints: formal and informal constraints. Formal constraints are explicit devises by humans, including laws (constitutions, civil and commercial codes, and criminal codes), political and economic rules, and contracts. Formal constraints are vitally important for a society’s social order and economic performance. However, formal constraints usually consist of a small part of all institutions that shape human interactions in a society. The other, larger, part of the institutions that govern social interactions is the informal constraints. The informal constraints include values, norms, and conventions. Informal constraints “come from socially transmitted information and are a part of the heritage that we call culture.”

The relationship between the formal and informal constraints is complex and the line between them can be fuzzy in certain areas (e.g., code of business conducts, which may be viewed as either formal or informal constraints, depending on how explicit they are). In order for the institutions to function efficiently and effectively, the formal and informal constraints must be consistent and mutually reinforce each other. Informal constraints form the bedrock for formal constraints. For example, the value judgment that “taking other’s property without the owner’s consent is wrong” is an informal constraint. Based on this moral code, formal constraint may be made, such as a law that declares that theft is a crime and should be punished. Strong informal constraints may increase the efficiency of formal constraints. For instance, in societies where people respect law highly, most disputes may be settled without going to the court, and the enforcement may also be less costly. At the same time, formal constraints may influence and reinforce informal constraints.

In our theory, the mode of governance (formal constraint) should be compatible with the culture (informal constraint). The practice of relation-based governance nurtures and relies on a guanxi culture. In turn, a guanxi culture reinforces the prevalence of relation-based governance in a society.
There is a common belief that the transaction costs in Western rule-based societies are too high to be efficient due to high lawyer fees in both litigation and deal-making contexts. This common belief seems to contradict our theory. As we argued above, the governance system consists of both formal and informal constraints. Because of the high legal costs in litigation and deal-making, people in rule-based societies try to rely on the informal constraints to govern their transactions and settle disputes. As a result, in mature rule-based societies, the culture that respects law and order tends to be strong, most transactions (such as buying stocks) are done without professional legal aid, and disputes are resolved out of court, making the average transaction cost low.

The Transition from Relation-Based to Rule-Based Governance

Market Expansion Calls for the Transition

By relying on relation-based governance and avoiding the high cost of setting up legal infrastructure, the catching-up economies can rapidly expand the market and further labor divisions to a certain point. The rapid economic development in turn will call for a more decentralized governance structure and eventually for rule-based governance. Thus, relation-based governance, paradoxically, will eventually destroy itself by facilitating market development. As markets expand and labor division increases, the number of transaction partners increases, and hence the average cost of relations will be increasingly higher due to the rising marginal costs of private monitoring. On the other hand, as the market expands and the number of transaction partners increases, the average cost of rule-based governance will decrease, since the large fixed costs will be shared by more firms and the marginal costs are negligible. When the average cost of rule-based governance falls below the average cost of relation-based governance, relation-based economies or firms will not be able to compete with rule-based economies or firms. Market competition will eventually drive relation-based governance to evolve into rule-based governance to capture the gains from economies of scale in rule-based governance and from more extended labor divisions.

The Lag in Cultural Change in the Transition

According to North’s institutional theory, formal constraints (mode of governance) may change very fast, literally overnight, such as government’s declaring a new law; whereas the informal constraints (culture) change much more slowly. For instance, a new culture may take a century to evolve. Thus informal constraints and formal constraints may not be entirely consistent.
This is evident by the fact that countries that have the same business laws (formal constraints) may have very different business activities and outcomes (due to different informal constraints). For instance, both Taiwan and China make their commercial laws based on German civil laws and have many commercial laws in common, but the court rulings and enforcement are very different. Such a discrepancy is especially pronounced in societies undergoing rapid institutional change. In a society that is undergoing rapid transition from relations to rules, the formal rules are being established, but a culture that respects the rules will take a much longer time to form. The lag behind of cultural change makes the newly established rules weak, ineffective, and inefficient, creating high risks of moral hazard in business transactions in such societies.

The Disruptive Nature of the Transition

Unfortunately, the transition from relation-based governance to rule-based governance is usually a discontinuous process. The decentralization of relation-based governance or a change of management teams can disrupt governance at least in the short term until rules are firmly established and widely respected, which is not an overnight process. When new management teams replace old ones and new players enter the market (e.g., the financial liberalization), the existing relation-specific information may become invalid, or the bilateral monopoly of private information breaks down. At the same time, the relationship with and between new players is yet to be established by repeated plays and tests. In particular, the arrival of newcomers makes it harder for an incumbent to commit to its existing relations.

The lack of an accurate, well-established information infrastructure at the microlevel in the relation-based society makes such a transition particularly hazardous. As we argued earlier, the rule-based governance system requires a well-established, trustworthy information system in order to work efficiently and effectively. Information noises due to fraud and inaccurate firm-level information must be reduced sufficiently. But a reliable information system cannot be built overnight. In the earlier stages of the transition, business activities based on rules are plagued by fraud in accounting, auditing, and legal documents, as shown in the publicly listed companies in societies undergoing transition such as China.

Worse yet, in the process of decentralization or transition, the discontinuous path of relation-based governance can hardly be followed by outsiders. More generally, relation-based governance is inherently nontransparent due to its local and nonverifiable information. Company or national annual reports in these economies often contain pretty photos of the leaders and window-dressing performance data which tend to be cooked up. Insiders will
be able to decipher the performance from these pictures (if a specific national leader visited a company, it may mean that lucrative contracts from certain sectors under the control of that leader will be awarded), while outsiders can only read the data and be misled. Given the fact that relation-based governance features nontransparency, nonverifiability, and relation-specificity, it is very costly to establish cross-country governance mechanisms among economies with relation-based governance and between economies with relation-based governance and economies with rule-based governance.

This incompatibility foreshadows the panic of outside investors. As we know, economic systems, especially financial systems, are vulnerable to panic, and an international financial system is even more vulnerable to panic due partly to the lack of a lender of last resort. Thus, an international financial system involving relation-based governance is most vulnerable to panic due to its incompatibilities with the rule-based system. This may be one of the reasons why the economies undergoing the transition from the relation-based to the rule-based systems, such as some economies in East Asia and South America in the late 1990s, are associated with financial disruptions and even crisis.

To be compatible with and integrated into rule-based economies, and to reduce transaction costs of enforcement, relation-based economies need to eventually liberalize their financial and other systems. However, liberalization can induce financial crisis. Outside investors, especially Western investors, have knowledge of rule-based governance, but they lack knowledge of relation-based governance. When a country with relation-based governance undergoes political and economic liberalization, outside investors observe the promulgated new rules. These rules, if fully implemented, may indeed be able to reduce the moral hazards of the fund users. Outside investors, however, are unable to observe the change of relations, particularly the possible deterioration of relation-based governance resulting from liberalization. Thus, they may invest more in a relation-based economy after learning of its liberalization programs. However, many new rules will largely remain like ink on paper; for example, the written traffic rule—"stop in front of red light"—means the same in all countries. Interestingly, it is well respected on the streets in Berlin, while not quite so in Beijing, where traffic light were used manually by the police (interestingly, in all major intersections in Beijing, both automatic traffic lights and the police simultaneously direct the flow of the traffic, but they are often inconsistent). Thus, liberalization can increase, rather than reduce, moral hazards, at least in the short term, and it provides opportunities for local financial intermediaries and other agents to loot money from investors. Often, outsiders perceive liberalization as an opportunity to invest, while insiders see liberalization as an opportunity to loot. These are the fundamental factors behind many failures of foreign investments in countries undergoing transition. To continue our traffic control
analogy, human directing will eventually be replaced by automatic traffic lights. Asia will transfer from relation-based to rule-based governance.

The Roles of Firms and Governments in the Transition

Who are the primary actors to initiate the transition? Are they individual citizens, business firms, or the government, or some combinations of the three? Before we discuss these questions, we must address the question “who are the beneficiaries of the transition?” The beneficiaries of the transition include business firms and citizens, since the overall transaction costs will be lower for the society. The business firms are the primary beneficiary of the rule-based system. However, individual firms are not in the position to initiate the transition. Since the benefit of a rule-based system is shared by all firms, the cost of any individual firm’s effort to initiate the establishment of rules will be greater than its share of the benefit, a typical free rider problem. Further, formal rules must be sanctioned by the government. Thus if the government does not initiate the establishment of rules, individual firms cannot effectively push for the transition.

Our theory implies that the mode of governance a business chooses depends on the macrobusiness environment. In a society where a reliable information infrastructure and an impartial, transparent and efficient legal system are lacking, firms must rely on relations to govern business transactions. Without changing the relation-based macroenvironment, firms cannot adopt rule-based governance at the firm-level or microlevel. In this sense, establishing a rule-based system is like establishing democracy, it is a public good and thus the government should take the leading role in establishing the rules. Why should the government in a relation-based society take the initiative to transform the society into rule-based governance? We argue that the fundamental drive is to compete in the global economy.

Government’s tasks to establish a rule-based system include establishing a legal infrastructure that supports impartial and transparent rule of law (this implies a system of checks and balances), establishing and enforcing standards for a business information system (such as accounting and auditing) that ensures the provision of accurate firm-level information, and nurturing and promoting a culture that respects the rule of law.

What would be a firms’ reactions to government initiation to establish rules? We can envisage a multistage game. In the first stage, the government establishes a rule-based system. In the second stage, firms respond to the rule-based system by deciding whether to adopt the new rule-based system in their business operations. In the third stage, the firms that adopt the new system gain greater efficiency and outperform the firms that do not. In the fourth stage, all firms are competing to adopt the new rules. Of course, the reality
may not be as simple as outlined in the game. In the next section, we will present examples of relation-based governance and difficulties of the transition from relation-based to rule-based system.

**CONTEMPORARY AND HISTORICAL EVIDENCES OF RELATION-BASED SYSTEMS**

**Contemporary Evidences of Relation-Based Systems**

*Longshuitou Village Mutual Help Foundation*

Professor Yu-shi Mao, a well-known public-interest advocate economist, founded a Mutual Help Foundation in a remote, poor village in China in 1993. The village is called Longshuitou (Dragon Fountain Head). The fund can only be loaned to peasants in Longshuitou Village. Professor Mao used his own money of RMB 500 (about US$60) to start the fund. Other academics also contributed. The fund now has about RMB 170,000 (US$20,000). The People’s Bank of China tells Professor Mao that the fund is illegal, because private citizens are not allowed to set up funds, a business monopolized by the state. However, because Professor Mao is well known, the Bank (many of the officers are Professor’s former students) lets the fund operate illegally.

Professor Mao hires three villagers to manage the funds. They screen loan applications and decide whom to loan to. They know every household in the village. They know their real purpose of borrowing, and their ability to pay back. In summary, they know the reputation of each household. This is why so far the fund has not had any bad loans.14

The key to the success of the fund is that it is relation-based: Professor Mao can operate illegally because the existing rules are not fair and are inefficient. Because of his relations with the banking authority and the fact that loan applications are processed by fellow villagers who know the applicants in person, the fund management has all the necessary mechanisms needed to make relation-based governance work: ex ante (their reputation and ability to pay), interim (how they use the money, and ex post monitoring (where to find them and how to make them pay back). The limitation of the fund is also relation-based. Its scale and scope are restricted to Professor Mao and to this particular village and cannot be expanded to other places. Furthermore, it cannot be imitated by the state banks.

**CITIC’s (Failed) Effort to Change the Way of Doing Business**

Around 1998, China International Trust and Investment Corp (the largest state-owned investment company, CITIC) hired McKinsey for US$1 million
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(a large amount by the Chinese standard) to develop a risk management system. McKinsey delivered a system later to CITIC. CITIC then applied the system to assess the risks of its loan clients and found that almost all its clients were not qualified for any loans. Some clients who came out with very high risk estimated by the system turned out to be the best clients who had very good payback records (the good clients pay regularly not because of their sound business, but because of relations). On the contrary, those with very low estimated risk were the worst clients—they just falsified their information—with the help from reputable accounting and auditing firms! All the CITIC branches that used the system were very puzzled and did not know what to follow: their time-tested old way of doing business, or the new McKinsey risk assessment system. Finally, the top management of CITIC said to these branches that the McKinsey system is "the direction we are going and is for the future."¹⁵

Risk management is a rules-based product. It relies on good information at the microlevel, such as accounting, auditing, notary, and credit reporting. When all the data are falsified, it does not work. The case manifests two points: first, it demonstrates the effort by firms in China to attempt to transform from the relation-based to the rule-based governance system; second, it shows the conflict between the rules-based system and the relations-based system, the difficulty of the transition, and the chaos during the transition.

Listed Companies Forging Documents

Ying Guang Xia, a star in China's fledgling stock market, saw its stock price rise from RMB 14 to 76 per share, a 440 percent increase in the year 2000. It was later discovered that Ying Guang Xia had been cooking up its numbers and falsifying contracts and profits for two years.¹⁶

Mai Ke Wen, another miracle in China's stock market, forged its records before it was listed in 1999. It conspired with CPAs and lawyers to make fraudulent papers to inflate its assets by RMB 213 million (US$25 million) and its profits by RMB 217 million (US$26 million).¹⁷

The stock market is intensively rule-based and relies on highly accurate micro-level information of the traded companies. When such information can be easily forged and becomes unreliable, stock markets cannot function.

Hong Kong: Highly Rule-Based, and yet Savvy on Relations

Hong Kong is viewed as having one of the best business environments in the world and for its efficient, transparent, impartial, and independent legal system, as well as for its effective anticorruption measures by its powerful and feared Independent Commission against Corruption (ICAC).¹⁸ For example,
Economist Intelligence Unit ranked Hong Kong as the world’s eleventh and Asia’s fifth for its business environment. This Western, common law-based business environment coexists with Hong Kong’s long and deep tradition of Chinese culture. Hong Kong businessmen rely on rules in Hong Kong and use relations when they do business in Mainland China. Their behavior is driven primarily by the political, legal, and economic environment rather than by their culture. A study on corruption by de Speville shows that the popular cultural tendency of tolerating corruption and relying on relations can be changed fairly quickly to anticorruption and to the law-abiding among Hong Kong Chinese.

**Historical Evidence of the Relation-Based System**

**American Business 100 Years Ago**

Historical evidence show that before impartial, transparent, and efficient legal infrastructures were well established, Western businesses were very much governed by principles very similar to those operating in economic relations in the developing world. In late nineteenth-century America, a few powerful individuals controlled virtually all major industries. MacDonald and Gasmann paint the following picture of the “time of giants”: “Frick started with coke and steel, Vanderbilt with steamships, Carnegie with steel, and Morgan with banking, but heavily involved in railroads. Relations between bankers and industrialists were close and, in many cases, incestuous in that many of the giants came to sit on boards of banks . . . the wealth of the plutocrats, their involvement in politics (often through bribery), control of the nation’s finance . . . , did little to endear them to the public.” Edward Harriman, another railroad giant of the era, “declared that if he wanted state legislation, he could buy it and that if necessary he could buy Congress and the judiciary as well.” The relationships between powerful businessmen and the government in late nineteenth-century America were like those in Japan, China, or Korea a hundred years later.

**Dun & Bradstreet: From Relation-Based to Rule-Based**

In 1841, when the Mercantile Agency (which later became Dun & Bradstreet) was founded, credit was not well developed and carried high risks due to the lack of both legal protection and accurate microlevel information. As a result, businesses tended to be family-based, running primarily on cash and relying on internal or relational financing. Early credit investigations relied as much on “characters” as on financial information. This situation remarkably resembles credit investigations in contemporary relation-based societies such as China, where personal background and character are more important than accounting data.
Now Dun & Bradstreet’s credit investigation in the United States is predominantly an assessment of business operation. It is about the ability to pay in the future based on a firm’s economic performance data. It relies on a microinformation infrastructure such as accounting and auditing, and is rule-based.27

CONCLUDING REMARKS

The theory of relation-based and rule-based governances argues that when the microinformation infrastructure is poor and verifiable business information is lacking, and the legal system is not impartial, societies and businesses rely on relation-based governance. The contemporary and historical evidences we reviewed above demonstrate that in the West, businesses were governed predominantly by relations rather than by rules when verifiable information was missing and legal systems were ineffective.

The theory of relation-based and rule-based governances offers a dichotomy that distinguishes the mode of business transaction governance in terms of information and enforcement, based on their different cost structures: a relation-based system and a rule-based system. We argue that from transaction governance perspectives, economic development is fundamentally a process of establishing relation-based governance first and then shifting to a rule-based system.

As the case of Hong Kong shows, people rely on either rule-based or relation-based governance depending on the business environment, not on their cultural background and habit. This evidence supports our dichotomy, which is based clearly on tangible economic concepts of costs—low, fixed, high, and rising marginal versus high, fixed, low, and flat marginal costs—instead of attributing the distinction to culture. The role that culture plays in influencing the mode of governance is that the two mutually shape and reinforce each other.

Our study may help governments and firms form their policies and strategies in societies under rapid transitions. In addition to pushing for the establishment of rules, governments in transition societies should also adopt policies that can minimize social and economic disruptions during the transition. Business practitioners, especially those from the rule-based economies, should pay ample attention to how relation-based governance works. When doing business in a relation-based society, they should thoroughly evaluate the prospective business partner using the three-stage monitoring strategy we outlined earlier, namely, the ex ante monitoring, the interim monitoring, and the ex post monitoring. Of the three measures, the ex post monitoring is the most important one. If you do not have the ability to punish defecting behav-
ior in the absence of an impartial and effective legal system, you should not do business in a relation-based society. Business practitioners should also be prepared to deal with the incompatibility between rule-based and relation-based systems, and the possible governance vacuum caused by the transition. It is hoped that this chapter will pave the way toward further studies on the dichotomy between rules and relationships in systems of governance in order to provide new insight on the interface of the two types of governance and the transition from the relation-based to the rule-based system. It is also critical that our arguments be put to the empirical test for further verification, especially quantitatively analyzed at country or firm-levels. This effort should also be extended to policy studies and recommended to minimize frictions between the two systems and the disruptive side effects of transition.

NOTES

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