perhaps Cass next can turn to a more fulsome analysis of the problem areas he identifies and offer a more detailed set of reform recommendations.

Another point that could have benefited from more explication is the relationship between the rule of law and economic prosperity. By limiting undue interference from the state and curtailing the arbitrary exercise of discretion by government officials, the rule of law provides individuals with the breathing space they need to pursue their livelihoods and better themselves in the manner they see fit. Certainly, economic prosperity ultimately is dependent, for instance, upon the extent to which individuals remain free to own, use, and exchange property absent excessive government intrusion. The positive relationship between economic prosperity and a rule of law regime is one that developing countries especially need to heed.

It is not surprising, then, that F. A. Hayek placed such emphasis on the rule of law in *The Road to Serfdom.* There, to come back around to definitional first principles, Hayek explained that the concept "means that the government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge."

All in all, Dean Cass has done well to remind that if we assert too often, without a sound basis, that judges in the United States act unconstrained by the rule of law, we may actually create a self-fulfilling prophecy. With expectations for adherence to neutral principles of law lowered, more and more judges may be tempted "to try a hand at creating the legal solutions they deem best suited to solve whatever problems they see." If that were to happen, it would be a tragedy not only for us here at home, but for those abroad who look to the United States as an example of a constitutional republic in which the rule of law prevails.

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Back-Alley Banking: Private Entrepreneurs in China
Kellee S. Tsai
Ithaca, N.Y.: Cornell University Press, 2002, 316 pp.

There is a popular saying in China: "Whenever there are policies from the top, the bottom produces counterstrategies" (*shangyou zhengce, xiayou duice*). According to Kellee Tsai, that has certainly been true of China's informal network for private-sector capital. In response to discriminatory government policies, private entrepreneurs throughout China have created an intricate system of "back-alley banking" to finance household- and firm-level ventures. Tsai, a political scientist at The Johns

Hopkins University, tells the story of that informal economy in her fascinating new book *Back-Alley Banking: Private Entrepreneurs in China.*

Private entrepreneurship is the driving force behind China's new economy. Since the start of the reform era in 1978, the private sector has grown at an annual rate of 20 percent, far above the economy's 8 percent average growth for the same period. More than 30 million private businesses have been established as well, which now contribute a significant share of tax revenue to the government and employ millions of people laid-off from failed state-owned enterprises (SOEs). The nonstate sector in China now accounts for two-thirds of total productivity and GDP.

Private-sector growth in China has taken place in an environment that is openly hostile to entrepreneurs and private businesses. Until recently, official state banks mainly extended credit to state and collective enterprises, not private ones. As of the end of 2000, less than 1 percent of loans from the entire national banking system had gone to the private sector. Furthermore, informal transactions are only weakly protected by the rule of law, and are often technically illegal. Despite those difficulties, China's private sector has thrived.

Tsai's premise is simple: "The stubborn persistence of informal interactions and informal finance is how China's economic miracle has been financed." That assertion presents at least two problems. First, given that it is technically illegal, the prevalence of informal finance is difficult to explain. Second, there is tremendous variation in the informal financing mechanisms and institutions that exist at the local level. Tsai uses a combination of top-down and bottom-up analysis to explain those conundrums.

According to Tsai, "economic structural legacies inherited from the Mao era" have created variation in local governments' attitudes toward the private sector. That situation, in turn, has resulted in varying degrees of implicit support for informal financial activity. However, that "state-centric" approach cannot fully account for observed variation in informal financing options at the local level. To explain this, Tsai argues that subtle differences among entrepreneurs are important:

> By definition, entrepreneurs are not passive products of structural constraints; they are innovative actors who draw on preexisting resources to create new products for the market and new lives for themselves. . . . Private entrepreneurs have varying social and political identities. These mediate their access to non-economic resources and networks, which in turn affects their economic strategies. . . . The so-called capitalist class is not a unified whole.

To support her arguments, Tsai draws on surveys conducted in localities scattered across three regions—Fujian, Wenzhou, and Henan. She identifies distinct forms of informal finance in each region, which she then classifies according to relative measures of legality and degree of institutionalization. Through official interviews and documents, Tsai also assesses the attitude of local governments toward the private sector.

In one important section, Tsai discusses why Chinese banks are discouraged from extending credit to private businesses. State banks are pressured to lend to SOEs so that unemployment and instability are minimized. Similarly, centrally and provincially defined policies favor certain industries through so-called policy loans. Structural barriers to formal credit exist as well. Most state banks lack the administrative and technical expertise required for processing individual loan requests. That inexperience notwithstanding, the banking system remains institutionally biased toward state lending; persistent interest rate ceilings in China restrain the ability of commercial banks to structure loans in a commercially viable manner for private borrowers.

The result has been that formal credit channels are closed to private businesses. Writes Tsai, "It is not surprising . . . that entrepreneurs have created a wide array of nongovernmental financing mechanisms and institutions." In Wenzhou, a southern coastal district in Zhejiang province, entrepreneurs have devised clever ways to circumvent financial regulation. To form a "hang-on household enterprise" (*guahu qiye*), a small business attaches itself to an SOE by paying to use its name, stationery, and account numbers. That allows the owner to evade taxes and obtain state financing. Other private businesses register as collectives with local committees. These are known as "red-hat" (*hong maozi*) enterprises, since they wear a collective label to obtain credit and avoid regulation. Surprisingly, local government officials often encourage such innovation. As one local cadre puts it, "If we had waited for the central government to allow certain practices, there would not be economic reform."

In Fujian, Tsai examines the different roles that men and women have played in informal finance. Rotating credit associations (*hui*), which allow participants to pool individually limited resources and allocate capital efficiently, are particularly popular among women. This is partly due to the sexual division of labor. In some regions, "men are prone to migrate to wealthier areas in search of employment or to take extended fishing trips, while women of marriageable age (late-twenties and older) are left to tend the fields, raise the children, and maintain the household." Structural explanations for this situation exist as well. For example, despite the gender-blind ideology of the Maoist era, many formal institutions still discriminate against women. Culture is also important; the "small" sums managed by *hui* may be regarded as demeaning to prospective male participants.

Throughout the book Tsai inserts interesting anecdotes about local entrepreneurs. The account of Mr. Chang from Henan province is revealing. In 1996 Chang owned a karaoke club in downtown Kaifeng City. The building was actually state-owned, but as a former employee of the governing agency, Chang had the necessary personal connections (*guanxi*) to lease the space. Chang used money he made trading futures to pay the lease and hire employees. Though Chang wanted to run a larger and fancier operation, he felt he needed more experience. Tsai writes, "I asked if by 'experience' he meant '*guanxi,*' and he nodded with a smile."

In the final sections of the book, Tsai compares the experiences of China's private sector with those of informal economies in other nations. She argues persuasively that the notion of a "developmental state"—a term often used to characterize other newly industrialized countries (NICs) in East Asia whose governments actively interfere in normal market activity through targeted industrial policy and credit allocation—does not apply to China. Though some regional and local governments within the PRC have certainly been directly involved with segments of the private economy, in practice there is no coherent development policy to which "the state," as a whole, adheres.

One conclusion, however, is surprisingly bold and misleading. Tsai asserts, "China's economic miracle challenges new institutional economics, which emphasizes the importance of property rights in advanced industrialized countries in the West." Though it is undeniable that the magnitude of China's economic development is unique, that phenomenon is perfectly consistent with the idea of "adaptive efficiency" posited by Douglass North and other so-called "new institutionalists." North and others believe that economies *can* grow without exclusive reliance on formal institutions to protect property rights and uphold contracts—but not indefinitely. Ultimately, growth in the informal economy must be constrained by high transactions costs and other inefficiencies. According to official statistics, that is already happening; private sector growth in China is slowing, as are flows of foreign direct investment (FDI). Without strong institutions and a rule of law, the private sector in China will surely remain underdeveloped.

Nevertheless, this is a remarkable book, and Tsai deserves praise for her insight and ingenuity. In the same vein as Hernando de Soto's *The Other Path,* she has compiled rare and valuable information on an informal economy that is, by definition, elusive and unofficial. Tsai is also unusually adept at acknowledging and building upon previous research in fields other than her own—in particular, economics and sociology. In this book she combines scholarship with great storytelling. *Back-Alley Banking* is essential reading for development economists and China scholars alike.

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Justice and Its Surroundings
Anthony de Jasay
Indianapolis, Ind.: Liberty Fund, 2002, 351 pp.

Justice and Its Surroundings is a brilliant work. It is also at times a difficult and a challenging work; the argument sometimes requires sub-