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1

Introduction

From Click to Boom

WANTOU VILLAGE, nestled in China's Shandong Province, sits in a region long marked by economic deprivation. For centuries, the Yellow River frequently flooded the region and acidified the soil, making it unsuitable for farming. Local households traditionally relied on crafting straw wickerwork for livelihoods, but the local market was limited. In the late 2000s, a returning migrant ventured into selling these handicrafts on Taobao.com, China's largest online trading platform, and quickly amassed a fortune. His success lured other villagers to follow suit. Since then, e-commerce has transformed the entire village—even its walls. The wall slogans that once exhorted the Communist Party's one-child policy have been replaced by e-commerce advertisements like "running around for a living away from home doesn't beat selling on Taobao at home" (在外东奔西跑，不如在家淘宝).[1]

Gyatsoling Rinpoche, who is recognized as a Tibetan living Buddha (the reincarnation of a past spiritual leader), started shopping online in 2014 to purchase religious items like yak butter lamps and candles. To his delight, he discovered that these items were cheaper online and that delivery only took four to five days to his temple in Chamdo, a city perched on the "Roof of the World," where brick-and-mortar options were limited due to high altitude, inclement weather, and a scattered population.[2]

The two anecdotes above are by no means unique. As of late 2022, around 850 million Chinese individuals engaged in online shopping, with 69 million directly or indirectly employed in sectors related to e-commerce.[3] The avid online shoppers refer to themselves as members of the "Hand-Chopping Party" (剁手党), humorously vowing to sever their hands to resist the temptation to splurge again. The spending spree peaks every year on the unofficial holiday of Singles' Day (November 11)—the world's biggest shopping bonanza, which generated four billion parcels in 2020.[4] If these parcels were arranged side by side, they would encircle the Earth at the equator approximately thirty times.[5]

China's e-commerce market is remarkable not only in absolute size but also in relative terms. Since 2013, China has consistently held the position of the world's largest e-commerce market. Nearly 50 percent of global online retail sales took place in China,[6] while the country accounted for only about 13 percent of global consumption in 2023, reflecting the country's disproportionate development in e-commerce compared to other nations. Jack Ma, a prominent figure in China's e-commerce landscape, encapsulated this disparity by stating: "In the US, e-commerce is the dessert, but in China, it is the main course."[7]

More importantly, e-commerce has been a catalyst for widespread socioeconomic transformations in China beyond the confines of the online market. For example, the burgeoning popularity of e-commerce has facilitated the rapid adoption of digital payment and mobile wallets, propelling China toward a cashless society. Even beggars have adapted, now collecting alms through QR codes. Not everyone was happy about this transformation, though. In Hangzhou, a leading cashless city, two individuals robbed three convenience stores in a single night—yielding a meager sum of 1,800 yuan ($260) in cash. Their unawareness of the city's cashless nature—as they were not local residents—inadvertently turned the criminal endeavors into a comical misadventure.[8]

There are many more headline issues in China linked to the e-commerce boom: the development of highly efficient logistics and express delivery industries, which now employ robots and drones in sorting and delivering packages; the rise of powerful platforms and the fall of brick-and-mortar stores; advancements in big data analytics and artificial intelligence capabilities; the emergence of novel industries like live streaming; concerns about data security and platforms' monopolistic behaviors—and the list goes on.

It is therefore not an exaggeration to assert, as *Businessweek* does, that "e-commerce has transformed China" (电商改变中国).[9]

The Paradoxical Market

This now-evident boom was, however, unanticipated. In the early 2000s, China's e-commerce sales were meager, lagging far behind other major economies.[10] Researchers of the period held a bleak view about the sector's growth prospects, citing various obstacles to e-commerce development: a lack of technological and public infrastructures; citizens' concerns about the safety (or lack thereof) of online transactions; the Chinese government's unclear policy stance toward this nascent industry; and an insufficient complementary service industry.[11]

Indeed, China's extraordinary online market seems to defy conventional wisdom in many aspects.

First, many political economists argue that strong formal institutions—including state-provided secure property rights, contract enforcement, and the rule of law—are crucial prerequisites for bolstering efficient markets.[12] For example, a strong legal system can prevent trading partners from engaging in fraud and breaching contracts, thereby nurturing trust and stimulating market activity.

A strong legal system should be particularly vital to the growth of e-commerce. After all, online transactions are not conducted face to face, and sellers and buyers are easily dissuaded by fraud, counterfeits, and information asymmetry. While many legal institutions are not specifically designed to regulate online activities, they play a pivotal role in preempting issues that could infiltrate the online market. For example, in countries with lax regulations on counterfeits, citizens naturally harbor skepticism toward online transactions, preferring face-to-face exchanges that enable product inspection before payment.

Nonetheless, China's e-commerce market took off *without* strong formal institutions to support it. A case study on China's e-commerce market in the 2000s highlighted this point: "China lacked norms and laws regulating online behaviors and preventing online fraud . . . In the US if you place a bid, it's a contract, and by law you need to fulfill that bid if you win the auction. That's very clear. People would be afraid of getting sued if they did not abide by that contract. In China people don't care. 'I place a bid, I don't want it anymore, tough luck.'"[13] Although China later made strides in legal developments that govern online transactions—including advancements in the general legal system (e.g., the Civil Code enacted in 2020) and the online sphere (e.g., the implementation of the E-Commerce Law in 2019 and the establishment of three specialized internet courts in 2017–18)—these legal frameworks emerged *after* the e-commerce boom. This aligns with the findings of Donald Clark, Peter Murrell, and Susan Whiting (2007), who show that improvements in China's legal system are generally a *consequence* rather than a *cause* of market growth.

Second, conventional wisdom also suggests that, in countries lacking strong legal institutions, market transactions often rely on personal networks, social ties, or face-to-face exchanges to proceed. Citizens prefer trading with acquaintances or familiar vendors because repeated interactions can hold the trading parties mutually accountable, thereby fostering honesty and trust in trade. In contrast, impersonal exchanges with strangers are often hindered by trust issues in environments lacking legal protections.

Yet most e-commerce transactions in China are *impersonal exchanges between small, anonymous traders in distant localities*. Trading parties are often strangers to each other, and they do not repeatedly interact due to limited consumer loyalty. One may assume that consumers buy from these unfamiliar vendors due to their large size or offering of branded products. However, in reality, China's dominant e-commerce model revolves around marketplaces.[14] Major e-commerce platforms like Taobao/Tmall and Pinduoduo do not sell their own products but host tens of millions of third-party sellers.[15] These sellers are predominantly small-scale, or even microbusinesses, and the majority of sales in the market come from nonbranded products or lesser-known brands.[16] Given the setup, why do Chinese consumers ever trust and trade with online strangers when legal protections remain weak?

The third counterintuitive aspect of China's e-commerce market is its leapfrog development. Many would naturally anticipate larger e-commerce markets in developed economies compared to China. Despite China's rapid growth, it remains a developing country by many international standards, with GDP per capita only about one-sixth of the US level in 2023. Developed economies have wealthier citizens, a stronger spending culture, and more widespread internet coverage, all of which are conducive to e-commerce development. Additionally, developed economies have stronger legal institutions and higher credit card adoption rates, which should offer better protection for online purchases and foster e-commerce growth.

However, China leapfrogged developed economies in e-commerce within a short period of time. In 2006, China's online retail sales were merely 3 percent of those in the United States. Yet within a decade, its online sales overtook those of the United States and the United Kingdom combined.[17] In 2019, China's online retail sales accounted for 21 percent of the country's total retail sales, almost double that of the United States (11 percent).[18] This leapfrogging trend applies not only to overall market size (see Figure 1.1) but also on a per capita basis. Compared to online shoppers in the United States, their Chinese counterparts make online purchases more frequently and conduct more than half (59 percent) of total monthly purchases online.[19]

Lastly, even more perplexing is the Chinese government's attitude toward the online market, which contradicts two prevailing notions. First, the Chinese internet is often depicted as a giant cage marked by pervasive censorship and state control, suppressing innovation.[20] However, it is often overlooked that there is a duality in China's control over the internet. While social media and communication aspects of the internet have always been tightly regulated, China's control over the economic facet of the internet has been much more lenient.[21] This autonomy has paved the way for e-commerce to act as a catalyst for innovations like mobile payment, AI, and smart logistics.

Moreover, China is known for its state capitalist economy, characterized by a large sector of state-owned enterprises (SOE) and active government

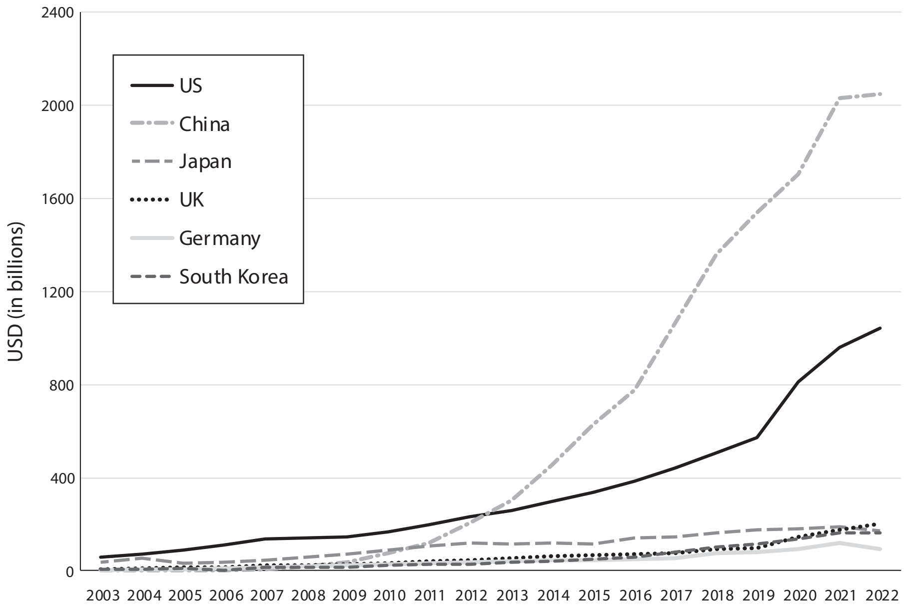

FIGURE 1.1. Online Retail Sales in China and Major Developed Economies (2003–22). *Notes*: In 2003, China's online retail sales amounted to only 0.47 billion USD, which was the lowest among the six countries depicted in the figure. This figure represented just 1/120th and 1/80th of the size of the online retail sales in the United States and Japan, respectively. *Source*: The data is derived from nominal online retail sales collected from various official sources and converted into USD using yearly average currency exchange rates provided by OECD. In the case of Japan, only business-to-consumer (B2C) e-commerce data is included, as consumer-to-consumer (C2C) e-commerce data is unavailable for many years.

intervention in economic affairs. Nevertheless, for as long as two decades preceding 2020, the Chinese government refrained from imposing stringent regulations on e-commerce, and SOEs had little presence in the market. While regulations were eventually tightened in 2020, it's noteworthy that this regulatory adjustment occurred *much later* than expected. Given the government's historically interventionist stance and formidable regulatory power, its prolonged leniency toward a highly disruptive industry dominated by private firms is surprising.

The Puzzles and Answers in Brief

These counterintuitive aspects of China's e-commerce market raise many questions.

If neither formal institutions nor informal networks apply, what constitutes the institutional foundations of this ostensibly well-functioning market? Why do customers trust trading with strangers despite the considerable risks involved? If legal institutions are so important for undergirding a market, why did the e-commerce boom happen in China, where the legal environment was weaker than in developed economies? Why did the Chinese authoritarian government, which has great capacity to directly regulate e-commerce, refrain from doing so for a surprisingly prolonged period? What are the political and economic effects of this paradoxical market boom?

These questions have not been thoroughly examined or even raised. Despite the rising prominence of e-commerce, boasting 2.6 billion users worldwide, many pundits, scholars, and journalists still treat e-commerce as merely a novel technology, a business model, and a market channel substituting for brick-and-mortar stores. Little heed has been paid to the *political-economic* aspects of e-commerce, particularly in non-Western contexts: its role as an institutional builder (creating institutions where the government fails to); a policy instrument (strategic government use of e-commerce to advance policy agendas); a catalyst for structural change (how e-commerce platforms reorganize state-business relations); and a battlefield for power (how governments interact with large platforms).[22]

This book represents a decade-long endeavor to analyze the political-economic dynamics of China's e-commerce market, the world's largest. Drawing on extensive field interviews, firsthand observations, and a wealth of original and proprietary data, this book aims to unravel China's seemingly paradoxical e-commerce boom and its consequences. Below, I offer a glimpse into some key findings of the book, addressing the questions raised earlier:

i. The institutional foundations of China's e-commerce market are neither formal institutional rules nor informal networks such as personal relationships. The market largely relies on the digital institutions provided by privately owned, mutually competing e-commerce platforms. Importantly, the state acquiesced, endorsed, and even partnered with this private provision of economic institutions despite its disruptive nature. This case is an example of China's novel route to institution building: *institutional outsourcing*,[23] in which the state implicitly or explicitly outsources institutional functions to key private actors such as digital platforms. This initially ad hoc process later became more explicit and formalized.

ii. China's e-commerce development has leapfrogged that of developed economies not *despite* its weaker rule of law, but partly *because* of it. China's e-commerce market is predominantly platform based. Compared to developed economies, China faced greater deficits in formal market institutions, and lower baseline trust among users in online transactions. Consequently, Chinese e-commerce platforms were compelled to establish more developed private market institutions (e.g., contract enforcement, fraud management, dispute resolution, and cheap access to loans) to instill trust among users—a necessity less pronounced for their Western counterparts operating in rule-of-law environments. These highly developed platform institutions have facilitated China's e-commerce growth. More importantly, equipped with such strong institutional capacity, platforms have evolved into "points of control" through which the Chinese state can strengthen its economic, legal, and political functions.[24]

iii. Institutional outsourcing explains why the Chinese state refrained from directly regulating the e-commerce market for a very long time, despite having the means to do so. E-commerce helps stimulate domestic consumption and entrepreneurship, which are crucial for China's growth. However, the market's nature, involving long-distance trade between strangers, requires strong market institutions in place to make people trust and trade. Yet, like in many developing countries, China's state-provided institutions are insufficient to support such a market, particularly in the early 2000s, when the e-commerce market first emerged. Reforming government institutions is a prolonged process fraught with political obstacles. Outsourcing economic and legal functions to private platforms, on the other hand, allows the state to build market institutions, strengthen policy enforcement, and foster institutional experiments—without undertaking these challenging tasks directly. It also allows the authoritarian government to distance itself from any public dissatisfaction that may arise from bad governance or failed institutional experiments.

iv. Institutional outsourcing to private platforms does not negate the need for government regulations; rather, regulations and outsourcing are closely interconnected. Without effective state oversight, large private platforms may exploit users and misuse their growing market influence, adversely affecting the quality of private institutions and, consequently, diminishing economic efficiency of institutional outsourcing. Conversely, if state regulations are excessively strict and arbitrary, they can impede the autonomy of private actors, stifling innovation and hindering institutional building, thereby also diminishing the efficiency of institutional outsourcing. Therefore, striking a balance between the power of platforms and the regulatory role of the state is crucial. The turbulent regulatory shifts in China regarding platforms—moving from a long-standing "hands-off" policy to a 2.5-year "regulatory storm," and more recently back to a supportive stance—illustrate the challenge of finding the right balance to avoid both regulatory vacuums and excessive control.

v. The institutional aspect of China's e-commerce development makes it more than a technological phenomenon. E-commerce has political-economic effects at both the individual and systematic levels. It generates individual-level effects on household welfare and digital inequality. At the systemic level, e-commerce fosters a national common market undergirded by a set of impersonal rules and digital enforcement, which, to some extent, erodes the authority of local governments. It also leads to a reorganization of the relations between the central government, local governments, and the economic agents.

While this book is contextualized in China's e-commerce market, its underlying theme is to investigate a central question in political economy: How can states foster growth in the absence of formal economic institutions, or if those institutions are frail? This question bothers many developing countries striving to prosper.

China's e-commerce boom suggests a potential growth strategy: encouraging the private development of economic institutions—particularly third-party enforcement—to foster *large-scale impersonal exchange*. This involves greatly expanding transactions among strangers in a society, enabling them to confidently trade with one another regardless of personal relationships or social identities. In the subsequent sections, I elucidate why large-scale impersonal exchange matters for growth, why most developing countries struggle to cultivate it, and China's approach to foster the e-commerce market—a nationwide market full of impersonal exchange.

Large-Scale Impersonal Exchange as a Source of Growth

From Personalized Exchange to Impersonal Exchange

To understand why large-scale impersonal exchange matters, we first need to go over the three types of exchange in human history, as summarized by Nobel laureate Douglass North: personalized, limited-scale, and large-scale impersonal exchanges.

Personalized exchange has existed throughout economic history, dating back to primitive societies. North characterizes this type of exchange as involving "small-scale production and local trade," facilitated by conditions such as "repeat dealing" or "cultural homogeneity (a shared set of values)" between trading partners. Notably, such exchange can occur without the need for third-party enforcement, such as legal enforcement of contracts.[25] Examples of personalized exchange include trading with a friend or consistently buying from the same vendor. In contemporary societies, especially in the developing world, where legal enforcement of contracts may be weak, personalized exchange prevails. For example, personal relationships, or *guanxi*, are considered critical in business dealings in China. People are inclined to trade with acquaintances because familiarity can reduce information asymmetry between trading partners, and repeated interactions can hold each other accountable. However, under personalized exchange, the available pool of potential trading partners is rather small, restricting the scope of the market and a country's growth potential.

To grow an economy, trade must expand beyond a small geographic entity or a culturally homogenous group: it must shift to *impersonal exchange*. This often refers to trading with unknowns—individuals who lack a personal acquaintanceship and anticipate no future engagements.[26] However, impersonal trade poses a significant challenge: establishing trust between strangers. The trust issue stems from substantial information asymmetry between unfamiliar trading partners. Without expectations for future interactions or the possibility of retaliation, there is a natural incentive for dishonest practices. Therefore, institutions play a vital role in facilitating impersonal exchange by assuring parties that contracts and property will be protected.

Impersonal exchange can be classified into two categories based on the governing institutions for trade. The first type is *limited-scale impersonal exchange*. This form of exchange relies on social and informal constraints to address the trust problem. In this scenario, trading parties are bound by "kinship ties, bonding, exchanging hostages, or adherence to merchant codes of conduct"; and "frequently the exchange is set within the context of elaborate rituals and religious precepts to constrain the participants."[27] For instance, even without personal familiarity, traders can securely trade with unknown members of other social groups if those groups have norms to effectively police their members' behavior. An example of this mode of exchange is long-distance and cross-cultural trade in medieval Europe. Because social constraints only work when both trading parties are embedded in social organizations, this type of impersonal exchange remains limited in scale.

The ideal form of exchange to foster an extensive market is "impersonal exchange with third-party enforcement."[28] I refer to it as *large-scale impersonal exchange* to distinguish it from the impersonal exchange that relies on social constraints for enforcement. In this scenario, the enforcement typically stems from a state-provided legal system that is both impartial and effective.[29] This impartial legal enforcement can alter the incentive structure for trading partners, discouraging dishonesty and opportunistic behavior. As a result, individuals can engage in trade confidently, regardless of their personal knowledge or social identity. This, in turn, stimulates market expansion, encouraging the division of labor, specialization, and ultimately contributing to economic prosperity. North regards impersonal exchange with third-party enforcement as "a critical underpinning of successful modern economies involved in the complex contracting necessary for modern economic growth."[30]

Institutional Hurdles in Developing Countries

According to North and Greif, the emergence of large-scale impersonal exchange is key to the rise of the West.[31] Yet very few developing states have successfully followed this path. The key to large-scale impersonal exchange—impartial legal enforcement—rarely exists outside of Western democracies. Why?

One factor is simply that developing countries lag behind in the market development stage. It took centuries for today's advanced economies to construct and refine market institutions. Similarly, latecomer countries need time to acquire the technical expertise and human capital essential for constructing such institutions and ensuring strong enforcement.

Meanwhile, political barriers frequently hinder the establishment of a strong rule of law in markets. Impartial legal enforcement requires treating everyone equally, regardless of whether they are a prince or a pauper, or whether a firm is politically connected or not. Achieving this often requires the establishment of strong formal institutions such as limited government and an independent court system to curb the arbitrary actions of rulers and resist political intervention in the ruling process. Yet political elites often resist being subjected to the law, fearing that an independent judiciary will undermine their authority. For instance, China has long stressed the importance of Communist Party leadership and supervision in the legal system. Zhou Qiang, the former head of China's Supreme People's Court, stated in 2017, "We should resolutely resist erroneous influence from the West: 'constitutional democracy,' 'separation of powers' and 'independence of the judiciary.' . . . We must make clear our stand and dare to show the sword."[32]

The lack of independent judiciaries makes it challenging for impartial legal enforcement to emerge. For instance, according to Jian Xu's (2020) empirical findings, even in economic domains where there is greater judicial independence than in the political realm, Chinese judges consider the political implications of their rulings. This results in a bias favoring politically connected companies, such as state-owned enterprises.

The lack of strong rule of law and impartial legal enforcement explains why it is rare to see large-scale impersonal exchange in developing countries. Instead, personalized exchange or limited-scale impersonal exchange prevail. For example, personal relationships are important for business dealings in China.[33]

Impersonal exchange exists on a limited scale, often based on social connections such as shared hometowns or kinship ties in places like Chaoshan. In some cases, large firms that have brand names and reputations can overcome the trust problem in impersonal exchange. Yet smaller businesses and individual sellers face more difficulties to assure their trading partners, relying more on personal or social networks to conduct business.[34]

This deficiency of large-scale impersonal exchange in China limits the scope of the domestic market, leaving much growth potential untapped. However, at the earlier phase of development, the Chinese government managed to generate substantial growth through an alternative strategy. This growth strategy does not rely on full-fledged market institutions (such as rule of law) as prerequisites for growth. It proved very successful—until recently.

China's Previous Route to Growth—and Its Limitations

A large body of scholarship has been dedicated to deciphering the so-called China miracle: why China has managed to achieve extraordinary growth with formal institutions that appear ill-suited for economic development by Western standards. For example, China does not have Western-style rule of law, credible checks on the executive power, secure property rights, or a clear separation of government and business.

While China does not have strong rule of law, it has established alternative institutional foundations for growth. This involves a combination of economic decentralization and political centralization.[35] On the economic front, the central government has delegated substantial authority to local governments, allowing them to improvise and enforce policies that drive the local economy.[36] Politically, the central government maintains a firm grip on local officials. Since the promotion of local officials is determined from above (in the nomenklatura system), they are strongly motivated to comply with central government directives, including those pertaining to economic guidelines.[37]

Within this institutional framework, China's past growth trajectory exhibits three key characteristics. (1) *State-led development*: the state is deeply involved in the economy. It maintains a sizable SOE sector and engages in state-led investment and industrial policy. (2) *Preferential treatment*: the state controls substantial business resources (e.g., bank loans, permits, and land), but these resources are limited. Absent strong formal institutions that ensure universal support to all businesses, the state grants preferential treatment to large firms (e.g., some foreign-invested firms or national/regional champions) and those with political connections (e.g., SOEs, connected private firms). (3) *Localized solutions* to development challenges and *interjurisdictional competition*: local governments are the primary drivers of the national economy. They formulate and implement policies tailored to local conditions, and competition among them encourages the adoption of market-friendly policies.[38]

These institutional arrangements fueled significant growth during China's early development stages, because they were well aligned with the country's dual growth drivers at that time—fixed-asset investments and exports. For example, state-led investments in critical infrastructure such as roads, bridges, electrical grids, and telecommunications effectively addressed China's infrastructural gaps, propelling overall economic development. Intense competition among local governments motivated them to offer policy incentives, enticing foreign businesses to relocate manufacturing lines to China, which significantly boosted the nation's exports. Through preferential treatment, the state prioritized allocating limited resources to large, relatively productive firms capable of managing exports, manufacturing, and infrastructure projects.

Nevertheless, by the mid-2000s, both of China's primary growth engines began losing momentum. For one thing, China's fixed-asset investments had reached the point of diminishing returns. There were ample issues related to infrastructure projects, such as overinvestment, investment misallocation, environmental problems, industrial overcapacity, and local debt problems. For another, China's excessive dependence on exports makes it vulnerable to protectionist backlash from countries such as the United States and to shocks in the global market.[39] The financial crisis of 2007–8 turned the risk into a reality. China's export slump brought lean times to the manufacturing industry and created risks of mass unemployment.[40]

Recognizing the urgency for new avenues of growth, the Chinese leadership started to advocate "economic rebalancing." This strategy first appeared as a guiding idea behind the country's economic policymaking around the mid-2000s, and it later became the central objective of China's Twelfth Five-Year Plan in 2011. Economic rebalancing aims to shift China's economic structure from an investment- and export-driven model to one led by domestic consumption and indigenous innovation. (In hindsight, China's efforts toward rebalancing have yielded limited overall results thus far, partly due to unforeseen circumstances compelling China to stick to traditional economic stimulus measures such as investments.[41] Nonetheless, the government's *intention* for rebalancing indeed prompted certain policy adjustments in favor of domestic consumption, including promoting e-commerce.)

The shift toward a consumption-driven model required expanding the domestic market. Despite China's already sizable domestic market, there existed considerable untapped potential for growth. With weak rule of law, market transactions often took place within personal networks or local markets. Therefore, a crucial step toward expanding domestic trading activities would be to establish a national common market characterized by large-scale impersonal exchanges, granting national market access not only to "whales" (large firms) but also to "minnows" (SMEs and individual traders). This would enable consumers to access a much greater variety of products, thereby stimulating household consumption.

Establishing large-scale impersonal exchange, however, seemed difficult in China. Conventional wisdom deems that this market usually comes with strong rule of law and impartial legal enforcement, which is not readily available in China. Some of China's institutional features also fall short in supporting such a market, potentially hurting it. For example, interjurisdictional competition incentivizes local governments to engage in protectionism and erect trade barriers on the borders of subnational jurisdictions, which may hurt the emergence of a national common market.[42] Furthermore, preferential treatment toward large and connected firms undermines the growth of small- and medium-sized enterprises despite their increasing significance in the Chinese economy.

Hence, it is intriguing to witness the rise of China's 800-million-user e-commerce market. This expansive and impersonal marketplace enables transactions among distant and unfamiliar traders, mainly comprised of SMEs and individual sellers. Such a market demands robust institutional frameworks to uphold contracts and deter fraud. But where do these institutions come from?

Institutional Outsourcing to Digital Platforms

Since the 2000s, China has effectively embraced a novel route to institutional building and enforcement: offloading it onto digital platforms.

I use the term "institutional outsourcing" to describe the scenario that, when state-provided formal institutions are absent, weak, or difficult to enforce, the government—either implicitly or explicitly—outsources a portion of its economic, political, or social functions to private actors of a certain type, which I call private regulatory intermediaries (PRIs), including digital platforms.

PRIs are not ordinary private actors. They possess the capability to provide private rules to either help the state establish new institutions or enforce existing institutions.[43] In cases where state-provided formal institutions are absent, PRIs develop private *substitutes*. Conversely, when formal institutions are already in place, PRIs can act as *supplements*, enhancing the enforcement of existing state institutions.

In chapter 2, I elaborate on which government institutional functions can or cannot be outsourced and why only a select few private actors qualify as PRIs. This discussion also explains why digital platforms are particularly suited to serve as PRIs compared to other private actors. Not all private actors can provide private governance, but as multi-sided markets, platforms' business models require them to establish private institutions for the various user groups they host. Platforms can also serve a large population, potentially the entire society, as their private institutions have remarkable scalability due to the zero marginal cost of digital products. Moreover, platforms can utilize extensive data and sophisticated algorithms to automatically detect rule violations and enforce regulations. Through techniques like A/B testing, platforms can also experiment with institutional modifications, promptly gather user feedback, and rapidly adapt to changing market conditions.

In the following, I use China's 800-million-user e-commerce market as the context to explain how institutional outsourcing works.

Private Institutional Building by E-Commerce Platforms

In China, the vast majority of e-commerce transactions occur on platforms rather than independent websites. These large e-commerce platforms are not merely connectors of sellers and buyers; they also play a pivotal role in institutional development.

Consider China's largest e-commerce platform, Taobao, owned by Alibaba. It contributes to the country's institutional development in three ways. First, Taobao has established strong private institutions to enforce contracts, prevent fraud, and settle disputes, effectively compensating for the lack of formal institutional support provided by the state. These private institutions include an escrow payment system, a sophisticated reputation mechanism, a credit scoring system, a fraud detection program, and even a unique jury-like system where millions of users voluntarily participate in adjudicating cases or shaping platform rules. These institutions have been widely adopted by other platforms, leading to a spillover effect (see chapter 3). Second, once platform institutions are established, the state can leverage them to enhance its legal enforcement. For instance, since 2015, the Supreme People's Court has collaborated with major platforms such as Taobao, JD, and WeChat to enforce debt repayment, reducing debtors' credit ratings and limiting their ability to purchase expensive items online.[44] Third, the state occasionally formalizes widely used private institutions, such as third-party payment services and platforms' online return policy, as shown in chapter 3.

It is crucial to acknowledge that, in Western countries, platforms such as Amazon or eBay also incorporate private institutions for contract enforcement or fraud prevention. However, these institutions are not as sophisticated as their Chinese counterparts due to lower demand. China's weaker underlying legal enforcement results in a higher prevalence of counterfeiting and fraud. Consequently, platforms in China face greater challenges in earning user trust and facilitating trade on their platforms. To overcome these obstacles, they must develop much stronger institutions and enforcement capabilities. The need for stronger institutions is illustrated in chapter 3 through the Taobao-eBay battle in the Chinese market in the early 2000s. eBay's transplanted institutions from Western countries proved insufficient to assure Chinese users of the safety of online transactions. In contrast, Taobao's focus on trust-building was the main reason it defeated eBay, despite eBay's first-mover advantage and much greater resources.

Interestingly, my discussions with platform rule makers in China revealed their acute awareness of the functional overlaps between state institutions and platform institutions. They didn't simply regard platform rules as internal company policies—they recognized their broader societal impact and their intricate relationship with the legal frameworks of the state. One platform employee shared: "We face similar market problems in the online market as government officials do in the offline market, albeit employing different methods to fix the problem."[45] Some platform rule makers even harbored ambitions to influence China's formal legal development, recognizing the possibility that the state might formalize platform rules that have proven effective.[46] This shows that the role platforms have played in institutional development is not entirely incidental but intentional to some degree.

The State's Outsourcing

Meanwhile, the state either acquiesces and gives implicit consent to platforms' private institutional building (*de facto outsourcing*), or explicitly delegates institutional functions to digital platforms through formal contracts or agreements (*de jure outsourcing*).

De jure outsourcing is clear-cut: it entails the state's observable action to outsource governance functions to platforms. For example, as discussed in chapter 3, China's Anti-Corruption and Bribery Bureau formally entered into a memorandum with Alibaba to delegate certain legal functions, aiming to combat commercial bribery. Moreover, as summarized in chapter 4, since the mid-2010s, nearly all provincial-level governments have signed strategic collaboration agreements with major platforms across diverse domains, including cloud computing, big data, rural e-commerce, and Smart City initiatives.

De facto outsourcing, however, requires additional clarification. This form of institutional outsourcing entails *deliberate inaction* by the state: despite having the capability to intervene or subvert private rules, it chooses not to. A prime example of de facto outsourcing can be seen in China's approach to the e-commerce market before 2020, when, despite the significant disruptions and controversies caused by e-commerce platforms, the Chinese government refrained from imposing stringent regulations for two decades. This hands-off approach granted platforms considerable autonomy to conduct institutional experiments and thrive, serving as a pivotal driver behind China's e-commerce boom.

The absence of stringent regulations did not stem from a lack of information about the issues caused by the e-commerce sector. Indeed, there were repeated calls from vested interests in China urging the government to impose strict regulations on the sector or even to ban it. For instance, in the early 2010s, state-owned banks repeatedly urged the government to ban Yu'E Bao, Alibaba's fintech money market fund, which rapidly redirected deposits away from banks. In 2015, e-commerce led to waves of closure of brick-and-mortar stores, prompting vehement criticism from many private entrepreneurs who denounced it as a "virtual" economy harmful to the "real" economy. In response, the government then resisted the pressure and avoided imposing stringent regulations on the e-commerce sector.

Some may also question whether the absence of stringent regulations reflects the government's inability to control platform power. This assertion may hold true in other countries, where governments are captured by powerful private businesses or where they are required to undergo lengthy legal processes to enact regulations. However, in China, the authoritarian government possesses many regulatory tools at its disposal. For instance, it retains ultimate control over the country's internet connectivity, evident from the internet cutoff in the entire Xinjiang region for ten months following an ethnic riot in 2009.[47] Moreover, from 2018 to 2019, the government decisively shut down the popular 200-million-user app Neihan Duanzi and mandated the closure of all peer-to-peer (P2P) lending platforms—numbering in the thousands—within a two-year period,[48] showcasing its capacity to intervene and shut down platforms when deemed necessary.

Instead, de facto outsourcing entails a situation where the government exercised *strategic nonregulation* over the e-commerce market before 2020. Unlike most government policies that entail active measures, strategic nonregulation involves a practice of *non-doing*—deliberately avoiding excessive regulations on emerging industries to foster their development. In contrast to industrial policies that provide businesses with land or capital, strategic nonregulation instead offers the much-needed autonomy in a country where government intervention can be frequent.

There is direct evidence of de facto outsourcing, indicating that the government strategically refrained from hasty regulations on the e-commerce sector. A research report conducted by a central government agency confirms that a key contributor to China's e-commerce growth is the "lax regulatory environment . . . with all levels of government encouraging experimentation and innovation without excessive intervention."[49] For example, in 2015, the State Administration of Taxation prohibited local tax authorities at all levels from conducting any tax inspections on e-commerce organizations.[50] In a similar vein, the State Administration for Industry and Commerce stressed in 2013 and again in 2016 that individual online stores were not required to register with local governments and obtain official business licenses.[51] These findings resonate with insights gained from interviews with local officials during the mid-2010s. For example, a provincial-level official from Shaanxi Province emphasized, while instructing other officials on e-commerce promotion, that the government's role is to "cultivate fertile ground" rather than dictate which crops should be planted.[52]

After 2020, China implemented stricter regulations on digital platforms. However, as shown in chapter 6, the goal of these regulations is not to shut down the private governance provided by platforms but to align it more closely with the state's interests. Consequently, institutional outsourcing has persisted. Despite heightened oversight, the state has maintained collaborations with platforms in rulemaking and governance provision. A notable post-2020 trend, however, is the increase in de jure outsourcing. Platforms are increasingly pursuing formal arrangements (such as memoranda of understanding or collaborative contracts) with the government to clearly define their responsibilities, request formal exemptions for accidental law breaches, and minimize compliance risks.[53]

The Regulatory Dilemma

Outsourcing institutional functions from the state to platforms does not always exempt platforms from government regulations. China's regulatory approach to e-commerce platforms has undergone significant fluctuations. Initially, until late 2020, the Chinese government maintained a hands-off approach with minimal regulations. Then, between late 2020 and mid-2023, there was a severe crackdown on big tech companies. Finally, in mid-2023, the government eased regulations and returned to a supportive stance. How can we interpret these regulatory swings, and why did the Chinese government turn to regulate platforms despite their outsourcing relationship?

In fact, regulation, or the latent capacity to regulate, is intricately linked to institutional outsourcing. First, if the authoritarian government lacks ex-ante confidence in its ultimate control over these platforms, it would not allow platforms to grow and wield such substantial influence. According to a Chinese legal scholar familiar with policymakers, the government's confidence in its own regulatory capacities—particularly its ability to exercise the "nuclear option" of shutting down the internet—led to an initial hands-off approach toward internet firms.[54] Second, government regulations act as a post facto mechanism to address issues in private governance. Without government regulations, large platforms may exploit their users, leading to a decline in institutional quality. Meanwhile, the state's outsourcing of institutional functions to platforms generates principal-agent problems. Through regulation, the government ensures that private platforms align with its political and economic visions, thereby facilitating a more seamless delegation of institutional functions.

The real problem is not whether digital platforms should be regulated, but how. The government faces a regulatory dilemma: inadequate regulation may lead to platform abuse of market power, while excessive regulation stifles private institutional innovation. In both scenarios, the quality of private institutions deteriorates, undermining the efficiency of institutional outsourcing. Achieving optimal economic outcomes requires striking a balance between platform and state powers: platforms must not be unchecked, and the state should avoid excessive intervention.

China's erratic regulatory shifts toward platforms underscore the difficulty in achieving the right balance. Chapter 6 elucidates how China's 2020–23 regulatory crackdown resulted from a situation where "platforms overstepped" and "the state overreacted."[55] It details how, due to the absence of robust state regulations before 2020, major private platforms overstepped their boundaries and exploited their market power, resulting in problems regarding data privacy, algorithmic manipulation, and anticompetitive behaviors, all of which harmed consumer welfare. While there were valid economic reasons for tightening regulations, the Chinese government overreacted to the challenges posed by platforms. It initiated a campaign-style crackdown on the tech sector with a high level of seriousness and intensity, often referred to as a "regulatory storm." This overreaction was likely driven by the influence of communist ideology, the absence of checks on executive power within the political system, and overconfidence in its regulatory capacity. The 2020–23 regulatory crackdown on platforms had dire consequences: the campaign-style enforcement significantly diminished tech firms' market value and profitability, injecting policy uncertainty into the broader economy. Ultimately, economic pressures prompted the government to halt the regulatory storm in 2023.

The Political and Economic Effects of E-Commerce

This book also examines the political-economic effects of China's flourishing e-commerce sector. Among e-commerce's multifaceted effects, I focus on two aspects that are central to China's economic and political governance.

The book presents the first causal evidence of e-commerce's effects on household welfare, as detailed in chapter 5. Despite prevalent anecdotes regarding the economic effects of e-commerce, there remains a dearth of rigorous empirical research to quantify the effects and identify the channels through which it influences household welfare. The study exploited a rare opportunity to conduct a field experiment in China, randomizing first-time e-commerce access across one hundred villages in three provinces. This experimental intervention is combined with transaction and shipping records from the e-commerce platform, price surveys of local retailers, and pre- and post-treatment household survey data. The findings suggest that e-commerce benefits the average rural household primarily through consumption effects (i.e., enhancing their purchasing power by reducing the cost of living) rather than production effects (such as increasing nominal income or stimulating entrepreneurship). Meanwhile, significant heterogeneity exists among the beneficiaries of e-commerce, with younger, wealthier households, as well as those residing in more remote villages, deriving greater benefits. The research has implications for inequality and rural development in the digital age.

In addition to exploring the economic impacts of e-commerce, the book investigates how e-commerce reshapes state-business relations, drawing evidence from interviews, an original national survey, and web-scraped store-level data. The central inquiry revolves around whether e-commerce will foster the rise of an independent business class in China. This question is crucial because, in other national contexts, the rise of a bourgeoisie independent of the state could precipitate political changes, such as demands for political rights or even democracy.

I find that, on the one hand, e-commerce indeed makes private merchants more autonomous from local governments. In China's economically decentralized system, local governments enjoy substantial power to support and regulate the local economy. Yet e-commerce has partially changed this status quo by offering national market access and private institutional support to private businesses. Local governments encounter difficulties in closing the regulatory gap, facing information gaps and coordination problems in regulating these online merchants. As a result, e-commerce participation seems to partially "liberate" private merchants from local government oversight.

However, this does not mean that e-commerce has created an autonomous business class; rather, private merchants remain regulated by the state, though indirectly, through large platforms. In chapter 4, I illustrate how the increased autonomy of private merchants results in a shifted dependency on platforms and how platforms establish extensive connections with central and local governments, serving as intermediaries of state authority to regulate merchants. Thus, the rise of e-commerce does not eradicate state-business interactions; rather, it centralizes them and moves the locus of interactions from the individual level to the platform level.

Methods of Inquiry

When this research was initially undertaken, given the rapid growth and relatively nascent nature of China's e-commerce market, there was a scarcity of prior research and publicly accessible micro-level data. Consequently, my research relied heavily on firsthand and proprietary data obtained through extensive fieldwork in different parts of China (see Figure 1.2). The research design comprised a mixed-methods approach, integrating both qualitative and quantitative research methodologies (see Table 1.1).

Qualitative Research

My qualitative research comprises three main parts. First, I conducted over two hundred semi-structured interviews. These interviews took place either in person during my fourteen months of fieldwork (intermittently between 2013 and 2016) across six provinces and two municipalities in China, or in the form of phone interviews (conducted between 2017 and 2023), when fieldwork was not possible. These interviews helped inform the book's theoretical framework, laying the foundation for the follow-up quantitative analysis. To attenuate research bias, I interviewed all major parties participating in or affected by the e-commerce industry, including online and offline merchants, online and offline buyers, village cadres, officials at the county/city/provincial levels of government, employees of various e-commerce platforms, and industries supporting e-commerce such as logistics and online marketing companies. My interviewees represented a diverse selection of geographic areas (i.e., urban/rural, coastal/inland, developed/underdeveloped) to reflect regional variations.

Second, I conducted online ethnographic research from 2013 to 2022 to counter problems common in field interviews, such as various forms of interviewer effects and snowball sample biases.[56] Unlike prior research that has used public forums and discussion boards for online ethnographic work,[57] I closely followed conversations in several invite-only, e-commerce-focused chat groups on WeChat, China's billion-user social media messaging app. Each e-commerce-focused chat group comprises up to five hundred members, including e-commerce sellers, government officials, platform employees, and researchers from various institutes. These groups conduct real-time, interactive discussions about the latest developments in e-commerce. Following the daily chats enabled me to: (1) garner truthful opinions in the absence of disturbing interview effects, (2) reach a large sample of subjects who were otherwise inaccessible, and, most importantly, (3) verify the long-term validity and stability of the theoretical framework derived from the field interviews.

Third, I performed content analysis of numerous e-commerce-related policies, news, platform regulations, and internal documents from local governments and platform companies.

Quantitative Research

On the quantitative side, this book exploits five datasets that are either original or to which exclusive access was granted. These datasets involve both observational and experimental studies. The first one draws on web-scraped infor-

TABLE 1.1. Summary of Research Methods and Data

Type	Methods	Description
Qualitative	Semi-structured interviews	Conducted more than 200 interviews over 14 months of fieldwork
	Online ethnography	Followed conversations in e-commerce-focused chat groups for 9 years
	Content analysis	Analyzed news, policies, and internal documents from local governments and platform companies
Quantitative	Web-scraped data	Analyzed web-scraped data from 1.76 million online stores
	National online survey	Surveyed 3,280 business owners (1,920 online merchants and 1,360 offline merchants)
	Randomized control trial	Randomized e-commerce access across 100 villages in combination with three sets of newly collected microdata: • Surveyed a random sample of 2,800/3,800 households within the 100 villages in two rounds • Surveyed local physical stores within the 100 villages for two rounds and collected 11,500 price quotes per round • Obtained 28 million transaction records from a large platform

mation from 1.76 million online stores that actively operated on China's largest e-commerce platform, Taobao.com, in December 2014. The raw dataset includes product-level data for each online store (e.g., store name, location, and each product's description, category, and price). By aggregating fine-grained information on individual stores at the level of the city/prefecture where each store was registered, the dataset helps uncover the regional distribution of China's e-commerce industry.

The second dataset is the China Entrepreneurs Survey, an original national survey of online and offline merchants. This survey provides rich information about the demographic, socioeconomic, and political variables of individual merchants. It enables statistical analysis of how the rise of e-commerce has altered merchants' political beliefs and relationships with local officials.

An additional three datasets were created in relation to a large-scale randomized controlled trial (RCT), also known as a field experiment, conducted in collaboration with a major e-commerce platform. The RCT involves randomizing first-time e-commerce connection across one hundred villages situated in eight counties of three provinces of China. This intervention is combined with three sets of newly collected microdata: (1) two rounds of

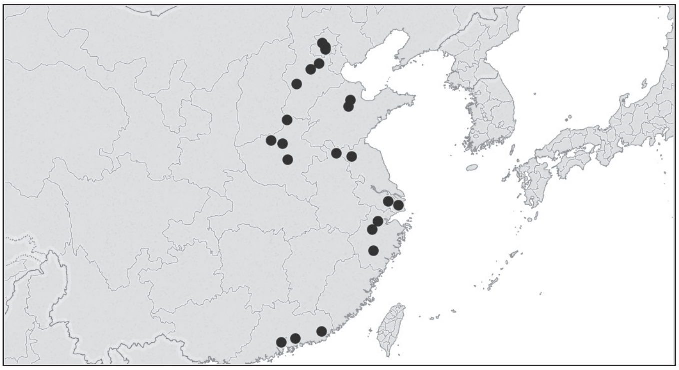

FIGURE 1.2. Map of Fieldwork Sites. *Notes*: The fieldwork sites include Beijing, Shanghai, Henan Province (Zhengzhou, Mengzhou), Shandong Province (Boxing, Feicheng, Zibo), Hebei Province (Shijiazhuang, Gaobeidian), Guangdong Province (Guangzhou, Jieyang), Zhejiang Province (Hangzhou, Tonglu, Lishui), and Jiangsu Province (Suzhou, Xuzhou).

longitudinal survey data collected from 2,800/3,800 households (roughly 8,600 individuals) per round, (2) two rounds of price surveys on local retailers, including 11,500 price quotes per round, and (3) 27.8 million transaction and shipping records obtained from the firm's internal database. As the first of its kind, this field experiment helps causally identify the impact of e-commerce on rural household welfare (e.g., cost of living, source of income).

Road Map

The remainder of the book proceeds as follows.

Part I examines the institutional foundations of China's e-commerce market.

Chapter 2 elaborates the theory of institutional outsourcing. It begins by describing a key puzzle in political economy: how developing states build strong market-supporting institutions under political constraints. I review existing theories on institutional building—the formal institutions approach, the competitive federalism approach, and the social connections approach—and discuss the limitations of each. I then introduce the theory of institutional outsourcing, defining the concept of outsourcing and specifying what government institutions can or cannot outsource. Importantly, the chapter explores why only a small group of private actors—which I term private regulatory intermediaries (PRIs)—possess the necessary capabilities to facilitate institution-building within this outsourcing framework, and why digital platforms qualify as PRIs. Lastly, I analyze the political logic of institutional outsourcing, as well as the durability and limitations of outsourcing to platforms as an approach to institutional development.

Chapter 3 applies the theory of institutional outsourcing to elucidate the institutional foundations of China's e-commerce market. In China, the overwhelming majority of e-commerce transactions occur on platforms rather than independent websites. These large private platforms serve as providers of robust market institutions when formal institutions remain inadequate. Through a case study on Taobao, I illustrate how large platforms establish strong private institutions to enforce contracts, prevent fraud, settle disputes, and allocate resources in a weak-rule-of-law environment. Furthermore, I illustrate how China's efforts to rebalance its economy prompted the government to not only tolerate but actively promote private institutional innovation by e-commerce platforms for an extended period, laying the groundwork for China's e-commerce boom. Furthermore, I provide concrete examples of institutional outsourcing from the state to platforms, indicating that such outsourcing has become more explicit and institutionalized over time.

Part II of the book examines the economic and political effects of China's e-commerce market.

Chapter 4 examines how e-commerce has affected the relationships between the central government, local governments, and economic agents, including the platforms and private merchants. Using data from field interviews, web-scraped store information, and an original national survey of private merchants, this chapter finds that the rise of e-commerce has restructured state-business relations. It centralizes these ties at the platform level, redirecting the locus of political engagement from individual merchants to these platforms. In particular, the chapter documents numerous strategic collaborations between platforms and the state, underscoring the growing significance of platform-state interactions.

Chapter 5 investigates and quantifies the various effects of e-commerce access. It first examines how e-commerce influences rural areas, focusing on the welfare of rural households. The investigation leverages the combination of a field experiment and the new collection of microdata. Furthermore, the chapter extends its analysis beyond the rural context, juxtaposing the experimental outcomes with other research findings to extrapolate the effects of e-commerce in urban settings. It also discusses aspects of e-commerce impact that are challenging to quantify but merit further research.

Chapter 6 delves into the reasons behind the Chinese government's evolving regulatory approach toward platforms: transitioning from a hands-off stance before 2020, to a period of regulatory crackdown from late 2020 to mid-2023, and finally returning to a supportive stance thereafter. Additionally, it examines the evolution of institutional outsourcing across these distinct periods.

Chapter 7 encapsulates the book's main findings and broad implications. I discuss how the study of e-commerce can offer valuable insights into significant shifts in China's political-economic landscape. These shifts encompass the evolving growth trajectory in China, the blurring of state-business boundaries, the increasingly collaborative provision of governance in China, and the dual-faceted politics of the internet, where commerce and control are intricately intertwined. Additionally, I examine supplementary cases from various global contexts, such as Grab, SafeBoda, the darknet market, US regulations on online child pornography and hate speech, and Facebook's "Supreme Court," to assess the circumstances under which the institutional outsourcing framework can or cannot be effectively applied. Finally, the chapter concludes by contemplating the future direction of China's e-commerce industry.

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