View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Erasmus University Digital Repository

Framing China: Transformation and Institutional Change

Barbara Krug and Hans Hendrischke

ERIM Report Series *Research in Management*	
ERIM Report Series reference number	ERS-2006-025-ORG
Publication	June 2006
Number of pages	39
Persistent paper URL	
Email address corresponding author	bkrug@rsm.nl
Address	Erasmus Research Institute of Management (ERIM) RSM Erasmus University / Erasmus School of Economics Erasmus Universiteit Rotterdam P.O.Box 1738 3000 DR Rotterdam, The Netherlands Phone: + 31 10 408 1182 Fax: + 31 10 408 9640 Email: info@erim.eur.nl Internet: www.erim.eur.nl

Bibliographic data and classifications of all the ERIM reports are also available on the ERIM website:
www.erim.eur.nl

ERASMUS RESEARCH INSTITUTE OF MANAGEMENT

REPORT SERIES
RESEARCH IN MANAGEMENT

ABSTRACT AND KEYWORDS	
Abstract	The paper offers a frame for investigating the extent to which decentralisation, and subsequent locally chosen institutions shape private organisational and institutional innovation. To include the numerous locally based "economic regimes" matters as the resulting business system reflects political institution setting and private organisational innovation. Such a frame is a necessary first step for empirical studies attempting to explain the heterogeneity of China's business systems, the emergence of hybrid organisations, and last but none the least, the different growth rates that can be observed across China.
Free Keywords	Transition Economy, Institutional Change in China, Private Business Sector
Availability	The ERIM Report Series is distributed through the following platforms: Academic Repository at Erasmus University (DEAR), DEAR ERIM Series Portal Social Science Research Network (SSRN), SSRN ERIM Series Webpage Research Papers in Economics (REPEC), REPEC ERIM Series Webpage
Classifications	The electronic versions of the papers in the ERIM report Series contain bibliographic metadata by the following classification systems: Library of Congress Classification, (LCC) LCC Webpage Journal of Economic Literature, (JEL), JEL Webpage ACM Computing Classification System CCS Webpage Inspec Classification scheme (ICS), ICS Webpage

Framing China: Transformation and institutional change

Barbara Krug
Rotterdam School of Management and UTS, Sydney

Hans Hendrischke
University of New South Wales, Sydney

Abstract: The paper offers a frame for investigating the extent to which decentralisation, and subsequent locally chosen institutions shape private organisational and institutional innovation. To include the numerous locally based "economic regimes" matters as the resulting business system reflects political institution setting and private organisational innovation. Such a frame is a necessary first step for empirical studies attempting to explain the heterogeneity of China's business systems, the emergence of hybrid organisations, and last but none the least, the different growth rates that can be observed across China.

Draft May 2006

INTRODUCTION

Economic Transformation is a process that facilitates the emergence of market-conforming organisations and institutions while discouraging the emergence of organisations and institutions which limit private exchange and the functioning of the price mechanism. Such a definition draws the attention to several aspects of economic transformation, which deserve some better understanding:

1. The *raison d' etre* for a business system based on markets is its superior allocative efficiency. In transition economies to demand a better functioning of the price mechanism must remain banal so long as markets and private property rights do not exist. Allocative efficiency in this case refers rather to the expansion of private voluntary exchange between economic actors.
2. Economic transformation depends therefore on the activities of private economic actors and organisations, i.e. there willingness and opportunities to establish organisations and agree on institutions by which to govern voluntary exchange.
3. Organisations and institutions can be harnessed when they become protected by national legislation and state enforcement, the sum of which defines an *Economic Regime* which allocates (positive and negative) incentives for embarking into or refraining from certain activities.
4. In transition economies such an economic regime is not a given but depends on ongoing legislation and regulation in the political sector which in turn depends on the institutions which structure political decision making. Subsequently the economic regime is not static, and changes to the regime tend to reflect a political compromise rather than pure economic rationale.
5. By its very nature economic transformation empowers individual actors. Searching for business partners, concluding business deals or establishing economic organisations, such as firms or networks asks for *organisational innovativeness*. Agreeing on procedures or governance of business relations, on the other hand asks for *institutional innovation*. When the state regards innovation as legitimate but outside the range of state interference yet protect worthy they

will be regarded as part of the formal constitution or legal. Otherwise they are regarded as informal (or illegal).

6. Organisational and institutional innovation define the transformation path as new organisations and institution emerge as a result of private business practices and the interaction between the new "private sector" and government agencies. In short, reforms, i.e. organisational and institutional innovations negotiated in the political sector and those evolving in the nascent business sector need to pass two tests: *They must facilitate the expansion of voluntary exchange (i.e. improve allocative efficiency), and need to politically feasible.*

It is the last point which explains why not all transition economies will end up with the same form of a market economy. If we call those who embark on organisational and institutional innovation as *entrepreneurs* then the whole transformation process can be expected to reflect the interplay between entrepreneurs, markets, and the political sector. Not much empirical research is available that would allow comparing the different transformation paths of transition economies, and by doing so identifying features that contribute to the speed of transformation or the country-specific characteristics of the future variance of a capitalist system.

The purpose of the paper is not to explain China and add to the empirical knowledge but to *reconceptualise* China into one coherent institutional interpretation. This is becoming possible on the basis of the rich empirical data available in China-related studies or management studies – and the authors fieldwork over five years.

The case of China

The purpose of the analysis is to offer a scaffolding by which the emergence of a private business sector can be linked to institutional change in the political arena, where after all economic reforms need to be sanctioned. That entrepreneurship responds to the political, economic and social environment is of course nothing new (Krug 2006). What is however needed is to find a frame that allows systematic and empirical investigation of

the causes why different business systems emerge and to which extent the differences in business systems reflect differences in institutional choice in the political arena and organisational and institutional innovation. China is a promising example for developing such a frame. As empirical studies have shown, it offers a data set where different business systems emerged within one political regime. It also offers a data set where the difference emerged within one "culture", provoking the question whether the notion of China as one culture is not a myth, or whether the influence of culture is not exaggerated in the literature.

China offers some more advantages when it comes to investigating organisational and institutional choice in transition economies:

- *Its overall economic performance*. China is obviously a case where economic transformation delivered the expected results, namely high growth rates and a quick change in the capital stock of an economy that allowed the country integrating into the world market. As empirical studies have shown, to achieve such a result "institutions matter". This begs the question whether China came up with organisational and institutional innovations that need to be regarded as crucial factors for explaining overall outcome.
- *Decentralisation*. China's reforms started with a large scale decentralisation programme, more precisely the transfer of resources, tax authority and regulatory power from the central state to lower (sub-provincial) administrative levels. This enabled the local state to opt for a specific economic regime, by setting "defaults" for what is regarded as within the limit of the reform programme, and what is regarded as "unacceptable" and therefore illegitimate. This is not to say that local administrative levels do not need permission from higher levels or the Party. It points rather to a weak central authority willing to accept a variety of different "experiments", the best known of which are the Special Economic Zones, the emergence (and disappearance) of township and village enterprises (TVEs), and most recently the large scale privatisation of small SOEs, the TVEs, and the urban collective sector. China therefore invites to search for features which explain institutional choice at the local level which in turn is a necessary first step toward

comparative studies which allow testing which set of new organisations and institutions facilitates economic transformation. Such studies are also needed for explaining why different regions in China develop quicker than others and whether China will end up as a nation with different domestic business systems.

- *Organisational and institutional innovations*. Some organisational and institutional solutions localities came up with are surprising. As they are no longer reflecting a socialist and not yet reflecting a market economy, they can be called (following Williamson 1985) *hybrid organisation or hybrid institutions*. To which extent these hybrids pave the way toward a capitalist system, whether they will disappear with ongoing marketization has so far not yet investigated. For example, whether networks are a necessary predecessor for functioning markets (as economic history would claim. Greif 1993; Tilly 2001), or whether they are the predecessors for rent-seeking coalitions (if not a Mafia: Hellman and Schankerman 2000; Frye 2002) is a major aspect of the Grabbing Hand- vs. Helping Hand controversy[1]. Before the effects of hybrids can be assessed, their emergence and functioning needs to be analysed. Are they cultural relics to be found everywhere in China and can therefore be expected to become a constituent factor in the post-transformation business system? Or, do they emerge as a "rational" systematic response to a situational constraint within the transformation process? If the latter is the case then hybrids might explain the variety of different business systems while it can also be expected that they disappear according to changes in the situational constraint.

Conceptual issues

The literature is, of course not unaware of the link between the external – political, economic or social – environment and organisational or institutional innovation within or around firms. Whether linked to the nation state (national innovation systems: Nelson 1992; North 2005), society at large (legitimation: DiMaggio and Powell 1983; Scott and

[1] The Grabbing Hand hypothesis was put forward by Frye and Shleifer (1997) and Shleifer and Vishny (1998), the Helping Hand hypothesis can be found in Oi (1995) and Walder (1995).

Meyer 1992), or in the form of industrial districts, organisational communities (Aldrich 1999), and networks (Nooteboom 1999a), all approaches stress the institutional context in which such entrepreneurship operates. Thus, there is a consensus that the societal/political environment provides business opportunities in form of positive incentives and available resources, and limits business opportunities by setting defaults for normative (DiMaggio and Powell 1983; Aldrich 1999) or cognitive (Witt 2000) reasons. However what is presented here is an analysis which precedes the employment of these approaches. *The attempt is to present a conceptual frame which allows singling out different environments, and different forms of organizational and institutional innovations so that future research can ask to which extend observable patterns of innovations can be linked to specific forms of environments.* The institutional environment here called *economic regime* might or might not set incentives for more innovation or innovation of a specific kind. The immediate advantage of such as conceptual set up is that geographical terms such as a region or a province need not longer be regarded as the proxy for the differences in the local business systems that can be observed.

One obvious starting point for an analysis of economic transformation is the comparative business systems literature (Whitley 1997; Hollingworth, 1994). With the help of a typology relying on a set of carefully isolated features that grasp the differences and similarities the analysis offers a systematic description of different market economies. While the typology of different forms of market systems relies on actual cases, from the point of view of transition economies the variety within what is called a capitalist system takes the form of “blueprints”. Some countries might opt for an economic system in which the central states still plays a major role, as in the case of France, others might take Thatcher England, as the model they want to copy. The findings of the comparative business systems-literature can therefore be used to describe “what is on the menu”, meaning which type of business systems will be considered when the political elite decide on transforming the economic system

With the CCP still in power it is hard to model the political process which caused the Communist Party to opt for their reform policy neither can we model the process by which the "local state" decides on a specific regime type. Yet, what can be done is to see the effects of "constitutional choice" on the transition path and the further interaction (between local and central government agencies) once decentralisation has been establishment. There is first the Public Choice Theory (overview in Mueller 1989) Leaving aside the normative approaches (Buchanan 1962) where institutional change (and economic performance) is linked to (democratic) voting mechanism, the public choice offers an extensive literature on "federalism" (starting with Buchanan and Tullock 1962; Oates 1972, Tiebout 1956; Inman and Rubinfeld 1998) where it is explored under which conditions jurisdictional competition is a strong surrogate for national legislation and ill-functioning market competition. For the case of China it was argued that Fiscal Federalism is a strong surrogate for missing market competition in particular when democratic voting mechanism don't exist. (Blanchard and Shleifer 2000; Cao, Qian and Weingast, Litwack 2002; Alesina 2003; Qian and Weingast 1997).

The third set of approaches centres on the observed clustering of economic activities when conventional analysis would predict that a spreading of activities offers higher rewards. This approaches can be found in behavioural economics; (Leibson and Zeckhauser 1998; Thaler, 1991, Schotter 1981), theories on effective co-operation (Buchanan 1965; Ostrom 1990; Greif 1993; Besley et.al. 1993), collective action (Olson 1965), and more recently social capital (Halpern 2005). Leaving behind the world where economic agents act as price (or institutional constraint) takers, the normative and strategic complications in bargaining situations reveal the scope and scale of institution building by private (as opposed to public/political) individual agents or groups. The emergence of new norms, new organisations and new business procedures – aside from the element of surprise that accompanies all innovation – help to streamline behaviour via the accompanying enforcement mechanism (Baurmann 1996; Schlicht 1998). Yet, simultaneously, these institutions also offer positive incentives for new actors to enter the economic market (Williamson 1985; 1993; Aoki 2001). In other words a multitude of jurisdictions can emerge as the outcome of private collective action governed by

collective agents, such as guilds, networks, business communities. Theses jurisdictions can be incorporated into the economic regime, thus making them part of the formal institutional architecture leading to a "corporatist state", be co-opted (and controlled) by a state bureaucracy as in developmental states, or be accepted as part of functioning markets indicating co-operation of otherwise autonomous economic actors (see in particular the literature on new economic geography such as Grabher and Stark 1997).

In what follows insights from all three set of approaches will be employed while empirical studies will be used to draw attention to the evidence that strengthen the argument. The basic idea is that if one can identify economic regimes on the one hand, and patterns of organisational and institutional innovativeness on the other, then further empirical test could contribute to gaining insights of institutional change, and the path dependency which starts by choosing the initial commitment to market reform. To this purpose the following offers a two-level analysis. It starts with a descriptive analysis of institutional change initiated and negotiated in the political sector. This includes to identify political actors, and to define proto-types of economic regimes, all of which compatible with a "capitalist" system amongst which political actors can choose. Though not much is yet known about the functioning of the process by which in Reform-China the different levels of government interact, some general features help to cautiously define some assumption on the selection of economic regimes. The second level of the analysis focuses on organisational and institutional innovation in and around the emerging private sector. Such a analysis also needs to start with the question about the new economic actors. As will be shown both the new business community and local government agencies, being the main force in China's economic transformation *jointly* establish new organisations and institutions. Before the analysis will elaborate on the three new institutions which distinguish China from other transition economies and whose contribution to the fragmentation of a national economic regime could be empirically tested, a short description of factors which influence institutional and organisational choice will be offered.

INSTITUTIONAL CHANGE IN THE POLITICAL SECTOR

Who initiates institutional change?

In contrast to the European cases of transition economies, China's reforms started with a *fuzzy commitment* where a socialist and a market economic sector still co-exist. Unlike the European cases where the commitment to a market economy started with privatizing state controlled assets and firms, in China the commitment to a "market economy" was split into a political commitment by the central government and an administrative commitment by local governments through devolution of power. Rather unique for a transition economy government agencies at all levels can "farm out" regulatory power and policy implementation in return for negotiated revenues[2]. The farming out policy is based on contracts between different layers of government, and often enough complements or competes with state activities implemented by specialised bureaucracies. The traditional dual leadership at local level can therefore be interpreted as the co-existence of *two forms of (state) governance*, namely bureaucratic procedures on the one side and contracting between different layers of government, on the other side which often creates confusion in the interpretation of Chinese statistics. Not enough is known about the "rules of the game" of the farming out procedure, and not enough data are available that would allow linking specific levels of government to specific "preferences" of economic regimes. Provinces can decide how to further decentralise regulatory power and tax authority to the effect that what is the prerogative of the township in one locality is the prerogative of a district in another locality (Zhu and Krug 2004). Thus for example the central government made an attempt to establish a "rational" tax bureaucracy (Zhu, Krug and Hendrischke 2004; Wong 1992, 2002; Brean 1998) to the effect that today there are national taxes levied and enforced by a national tax administration next to the tax farming system which dominates local taxation. It is therefore more appropriate to talk about *local autonomy* characterised by horizontal and vertical competition for resources and regulatory power than to talk about fiscal federalism.

---

[2] A detailed Analysis can be found in Zhu, Krug and Hendrischke 2004)

A short overview over the literature reveals that most analyses fails to operationalise what is meant by the local state. Regardless whether the Fiscal Federalism argument (Qian and Weingast 1997; Qian 2000) or the empirical studies on "Central-local" relations or the tax system (Gong and Feng 1994, Wong 1992; 2002; Brean 1998), the studies are unspecific when it comes to which level of government or administration is involved in which kind of regulation or taxation. On one side this corresponds with the decentralisation policy of the central state which on purpose left further decentralisation moves to the provinces. On the other side this reflects a "weak" central state where different localities can opt for different power sharing arrangement. Undisputed, however is, that sub-provincial government agencies, in particular at county and township level together with new non-state firms became the main agents for institutional change in China. As will be shown later, *local autonomy* is one of the institutional innovations which characterise China's emerging business systems.

What is there to choose: a typology of economic regimes

Based on the empirical studies of the comparative business systems literature three types of economic regimes can be described all of which are compatible with the initial commitment to a market economy, and which could serve as a blueprint for transition economies. The Arm's Length State best imagined as the regime that comes closest to the neoclassical state, the Developmental State in which state agencies control sectors and plan economic development, and the Pre-corporatist State where the state delegates authority to certain social groups which unlike in the usual definition of a corporatist state do not need to be formally recognised (Schmitter 1974).

Table 1: Economic Regimes

Key characteristics	*Arm's Length State*	*Developmental State*	*Pre-Corporatist State*
Involvement in development and transformation	State as neutral arbitror Low taxation small range of regulation	State as planner and regulator resource control Planned development	State as "partner" Authority-sharing
Scope and nature of	Contractual relations	Sector-specific control	Bargaining with the

voluntary business relations	between equal judicial persons		corporatist sector
Organizational choice	Toleration of new organizational forms	Sector-specific organizational forms	Fuzzy organizational choice
Property rights regime	Individual, Private law	Public-private	Collective consensus
Innovation and experimentation	Market driven R&D firms	State education State R&D	Network-driven
Selection, economic performance	Competition	State defined constraint	Internal negotiation
Standardisation Technical and business practices	Investor driven Market wide	Technical \Sector wide	Inertia Random change

At the most general level the three types can be distinguished by the following features:

(1) *Involvement in transformation and economic development.* In the Arms Length State the state remains aloof, as a neutral arbitrator, limiting itself to a set of tasks defined by the provision of public goods and connected with national sovereignty. In contrast the Developmental State sees itself as a dominant planer and regulator of economic development. For doing so government agencies will be established that directly control resources, protect industries or offer monetary incentives for politically agreed upon economic activities, such as investment in R&D or education. The Pre-corporatist State establishes and safeguards its legitimacy by authority sharing with social groups whose co-operation is perceived as essential for economic development.

(2) *Scope and nature of voluntary business relations.* The Arm's Length State is characterized by rule-based governance and a (independent) judiciary guaranteeing contractual security for business partners. The Developmental State in contrast defines (sector-specific) constraints for those economic activities over which the state claims control, which in turn will be enforced by a professional bureaucracy. Voluntary exchange (or investment) is thereby limited to sectors outside state control. In the Pre-Corporatist State business relations depend on bargaining within the corporatist sector while voluntary exchange is limited to activities not claimed by "networks".

(3) *Organizational choice*. The Arm's length state tolerates all forms of co-operation and organizations as long as their purpose is not to limit competition and free exchange, such as monopolies. The Developmental State in contrast often enough establishes state

controlled monopolies or cartels, defines entry barriers for newcomers often including specific requirements for the organizational form. The Pre-corporatist State networks can, but need not be protected as the dominant form for organizing production and exchange. Whether network-supported sectors develop into state-guaranteed (local) monopolies depends on domestic and external competition, as well as the interaction between these networks and the political leadership.

(4) *Property rights regimes*. While the Arm's Length States establishes private property rights the Developmental State limits those to resources and sectors over which the "public" does not claim control. The Pre-corporatist State knows a large range of collective (or rather fuzzy) property rights where individual interests get represented by a collective actor.

(5) *Governance (incentives) around Innovation.* In the Arm's Length State innovation is market driven with firms and their R&D department as major agent. The Developmental State attempts to steer innovation via planning, formal education, or the establishment of science parks etc. supervised by a group of professionals within the state bureaucracy. In the Pre-corporatist State innovation and experimentation depends on the co-operation and support of those groups, which can mobilize the necessary resources.

(6) *Governance of Performance and Selection criteria*. Which business venture succeeds or fails is decided in the Arm's Length State by market forces, i.e. competition, while in the Developmental State technocratic entry and exit criteria supplement market forces. In the Pre-corporatist State where individual property rights are weak performance depends on the evaluation criteria of networks or are negotiated between networks.

(7) *Governance around Standardization of technical routines and business practices.* Finally, the establishment of (technical) routines, or business practice, is driven by market forces in the case of the Arm's Length State. In particular investment flowing into that routine or practice that promises highest returns will ensure the best practices get imitated across sectors. In the Developmental State standardization follows decisions within the state bureaucracy, while in the Pre-corporatist State standardization is either missing due to group-specific protection or appears as random change.

Inevitably none of these types will be found in reality in its “pure” form. What came closest to one of these types (the Arm’s Length State) were the attempts in Balcerowicz’s Poland, or Klaus’ Czech Republic. The case of China is instructive as one of the most striking features of the Chinese economy is the co-existence of all types of economic regimes *established by different layers of government*. The typology invites empirical studies which cluster provinces, regions or township accordingly. Thus a procedure allows investigating which regime type facilitates economic growth. It would also prepare a common ground for research which kind of a business system, private sector, or types of firms will emerge.

Limits of Choice: Factors influencing the selection of economic regimes

Insights form the analysis of transition economies and New Institutional Economics but also growth theory allow listing factors for explaining the choice of an economic regime by different localities (and empirically test it).

(1) *Market size.* Large size of production increases productivity and unleashes industrialisation (Romer 1986; Lucas 1988). Likewise, size of [expected] demand is crucial for the emergence of entrepreneurship and inflow of investment (Shleifer and Vishny 1987).

(2) *Labour market for “professionals”*. The availability of skilled workers of people with an education that at low costs can be mobilised for working in the envisaged new private sector and new industries defines another threshold for the “spontaneous” development of markets and new sectors (Nee and Peng 1994; Xu 2001. See also Yarrow 1998; Bian 1997; Benjamin and Brandt 2002).

(3) *State ownership.* It is less the distribution of industries that explains the diversity in income, or but the ownership structure, more precisely the share of industries controlled by central [as opposed to local] planning. The higher the share of the centrally controlled sector, the less the range of activities for which local jurisdiction can design an economic regime (Smyth and Binder 2004; Guthrie 1999; Nee 2000).

(4) *Income level.* It is less the direct comparison of personal income, which is impossible to calculate in a socialist economy, but rather the transfers from the centre to local budgets which decides personal income and income chances. Moreover, The more dependent on allocations form the central budget the smaller the disposable revenue local government agencies have for financing institutional change (Bao et.al. 2002; Bean 1998; Zhu, Krug and Hendrischke 2004).

(5) *Attractiveness for (foreign) capital inflow*. Additional capital leading to work place generation in new firms and industries mitigates institutional change. As was shown elsewhere (Cao et.al. 1997; Braunstein and Epstein 2002; Chen 1997a; 1997b; 1997c; 1997d) locations where new firms offer workplaces find it easier to dismantle the socialist sector by laying-off workers, i.e. choosing a market approach for re-structuring industry, than places where such a policy would create long-term unemployment.

It is not hard to see that the smaller market size, the more dominant the centrally controlled state sectors, the more relying on budget transfers and/or the less attractive for FDI, the smaller the range of activities the local state can formulate, implement and finance. An economic regime of the type of a Developmental State must remain ineffective so long as the local state fails to mobilise support of such groups which control visible, i.e. physical assets, or invisible, i.e. human capital and local knowledge, resources. It is this point which makes the type of the Pre-corporatist state such a viable alternative if it should be better placed to align the interests of the new business sector and local government agencies.

(6) *Capital stock.* Investment decisions in the past followed political, military-strategic decisions rather than economic considerations (Bickford 1994). For this reason the capital stock of local jurisdictions and its infrastructure differ widely to the effect that in particular communication and infrastructure offered an advantage [or disadvantage] at the beginning of the reforms. Another feature is that due to the socialist past private capital accumulation is missing. How to privatise the state sector depends in this case on the decisions to whom the initial ownership rights are allocated which in the case of China had been the village.

(7) *Land ownership*. To embed ownership rights locally allowed local jurisdictions choosing between different courses of action, such as selling assets, or use-rights, establishing first ownership rights for firms, or MBOs (Krug and Hendrischke 2003; Oi and Walder 1995; Unger and Chan 1995. For a more general discussion see Vickers and Yarrow 1991). Moreover, being the de facto owner of land allowed local jurisdictions to convert land into Special Economic Zones, i.e. establishing two economic regimes within the boundaries of their jurisdiction. In general, as will be shown later land ownership strengthened local autonomy in particular in regions where land prices increased quickly, thus offering local governments an income source outside central control.

(8) *Positioning of local jurisdictions within the national political hierarchy*. It is less the general opposition to the reform course but the relative positioning of local leaders that proves to be essential in policy decision making, such as choosing an economic regime. In the One-Party system of China, local politicians have to accommodate two "constituencies": the upper-level (Party) hierarchies and, increasingly more, local demand. Formal and informal connections help to gain access to information, transfer income, and approval to experiments. Thus, for example, shortage of capital [for necessary investment] can be overcome either by lobbying for central subsidisation or by mobilising local resources, in return for handing out [economic] privileges or sharing authority with certain social groups (Goodman 1995; Nee 2000; Lan 2001).

In short, the legacy of the past left an unequal distribution of assets and power positions. The result is a clear division between localities that face a soft budget constraint, and, at the other extreme local jurisdictions which almost completely depend on (national) transfers. As empirical studies have shown income form land management can easily add up to fifty per cent and more of total revenue (Zhu et.al. 2005). The more physical and political assets controlled by a local jurisdiction the softer the budget constraint and the more leeway it has to choose that economic regimes it sees best suited.

(9) *Administrative innovativeness*. Institutions need to be established which *re-align the interests of political and economic actors* (Nee and Cao 2004) by offering incentives for investing in market-conforming human and social capital. From this perspective the

decentralisation which marks the beginning of economic transformation can be seen as a move by which the central government secured compliance with the reform course by transferring resources and regulatory power to the lower administrative levels on whose compliance the enforcement depends. As said before China established a peculiar incentives structure in form of a dual administrative system that is expected to underpin the agreed upon multi-layered structure of governance. Aside from a central bureaucracy where professionals in return for a safe fixed salary act as agents of national or local governments, national legislation offers the possibility to "farm out" government activities to local jurisdictions or social groups. Coordinated via contracts with the superior agencies or informally via networks such an authority sharing system ensures that the lessee, i.e. the local governments can capture the gains "at the margin" and thus directly profit from local economic development. Regardless whether employed in taxation, land management, privatisation of industrial assets, or setting up local regulatory regimes this farming out policy ensures that the transformation gain is divided between the central and the local level (see the different contributions in Brean 1998. For a comparative view see Shleifer and Vishny 1994; 1993; Litwack 2003).

To sum up, the factors singled out above can be assumed to influence institutional choice. In general, it can be assumed that only very few local jurisdictions will opt of an Arm's Length state, so long as the *national level* fails to establish the necessary infrastructure, such as the reforms of the judiciary, banks and financial market, and property rights, all programmes which would exceed local resources. Whether to choose a Developmental or a pre-corporatist regime will depend amongst other things on the ability to mobilise entrepreneurship and local innovation in the emerging private sector.

ORGANISATIONAL AND INSTITUTIONAL INNOVATION IN THE PRIVATE SECTOR

Economic regimes are established to last (North 2005). Yet in transition economy the problems looks differently. Here *the dynamic process behind economic transformation is*

driven by new and old economic and political actors who search for institutions that help to better cope with uncertainty, and mitigate transaction costs which can be assisted by changes in the original economic regime (Qian 2000; Nee and Cao 2004; World Bank 1994). It is worth emphasizing that the case of transition economies is one of institution building, i.e. searching for institutions, and not one of institutional change where individual actors compare two or more known institutional alternatives whose expected returns can be calculated. Before the Chinese response to uncertainty, transaction costs and political constraints is described, some remarks on the new economic actors:

Who initiates organisational and institutional innovation?

The *new economic actors* which appear once an economic regime has been chosen are characterised by the fact that they are in control of scarce resources. At the local level this are entrepreneurs, firms (i.e. corporate actors) and local government agencies. To start with the former: How to co-ordinate individual and firms' economic business behaviour is not completely determined by any of the three economic regimes described earlier. Instead private actors contribute to institution building when they conform to one business practice (Krug 1999). The reason for doing so can be economic considerations when individual actors anticipate network effects due to positive externalities on the demand side. Another reason can be that these business practices are regarded as the "normal" way of doing business so that the functional value of such a form of governance remains unscrutinized (Krug 2002). In this case cultural factors begin to play a role, as these routines are remembered forms of how to invest, operate a firm and how to conclude a business. Moreover, cognitive and social legitimation are forces which influence the decision of entrepreneurs (Baron and Hannan 2002) to embed firms in traditional social relations (Coleman 1986; Greif 1993; Granovetter 1985) which as many field studies have pointed out leads to starting a firm within a local context with whom the entrepreneurs are most familiar with.

The need to cope with an insecure quickly changing environment but also the lack of private savings or capital markets and the need to quickly acquire scarce market and political information make co-operation are profitable endeavour. As will be shown presently the co-operation can take the form of an alliance with local government agencies formalised as local autonomy. While a co-operation rent will be generated irrespective which economic regimes had been chosen, the sharing parameter depends on the regime-type with the Arms' Length State leaving the highest share in 'private' hands. Networking on the other hand can but need not include government agencies. The reason for networking as a business strategy is that that competences and capabilities accumulated within the local nexus are non-transferable while networks open business opportunities across China. Before the three forms of new organisations: local autonomy, networks and corporate governance will be explained in detail, the question needs to be asked which factors shapes organisational and institutional innovation.

Factors shaping organisational and institutional innovation.

Most studies in Comparative Business Systems or New Institutional Economics assume that a constitution or national legislation establishing "defaults" for appropriate (market-conforming or honest) behaviour function as hard constraints. In China as in all transition economies this assumption needs to be modified. Institutional change is frequent, caused not only by political changes but also by technical-economic development and the reaction to the distributional consequences of the transformation. Moreover the institutions which define the economic regime are rarely effectively enforced as the necessary agencies (the judiciary or state agencies) are missing or ill-functioning. Instead of imposing a hard constraint on individual economic behaviour, the economic regime in order to function depends on voluntary compliance or organisational and institutional innovation, which harnesses the formal architecture.

The soft institutional constraint in China takes the form of a *weak central authority* where the co-existence of different local economic regimes allows economic actors avoiding the constraint at low cost. They can either move to (invest in) another jurisdiction, thereby

exploiting regulatory arbitrage, or they can influence local policy and formal institution building via their interaction with local government agencies. The emergence of a business system in China – and its difference to an economic regime – depends therefore on organisational and institutional innovation by private economic sector within the areas where the state does not interfere and on the interaction between private actors and the local government agencies.

In the literature two distinctive set of approaches attempt to explain private economic behaviour in China. One group of authors assumes that organisational and institutional innovations reflect cultural norms, in particular networking or *guanxi*[3]. Another group stresses *transaction costs* to which private economic actors react in a systematic way[4]. To claim that culture, in the sense of norm-driven behaviour on the one side, and rational behaviour, i.e. systematically reacting to positive and negative incentives, are mutually exclusive misses the point. As is suggested in what follows, culture shapes the opportunity set for organisational and institutional innovation while transaction costs determine the employment or modification of such norms or traditional institutions. Three cases of organisational and institutional innovativeness can be singled out. Though the poor data base does not allow cross – economic regime comparisons, there is enough illustrative evidence from field work to claim that these institutions do not reflect local or national culture but suggest search for other – economic or institutional factors.

New organisations and institutions

Corporate Governance as a means to reduce uncertainty.

In a broad definition corporate governance refers "… to a whole set of legal cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the

---

[3] E.g. Tong and Yong 1998; Tsang 1998; Redding 1996; Park & Luo 2001; Luo 1997; Lovett *et al.* 1999.
[4] E.g. Batjargal & Lin 2002; Xin & Pearce 1996; Wank 1996; 1999; Gold *et al.* 1998; Bian 1997; 2001.

activities they undertake are allocated." (Blair 1995, 3). In the case of China where private firms need to be established and empowered, corporate governance refers to the *search for a governance structure which is able to cope with political and market uncertainty while setting incentives for investment and commitment.* This search process is reflected in the fact that economic development has been accompanied by organisational change in firms to the effect that today a multitude of different types of firm co-exist that are not captured by the official statistics[5].

Different localities in China still have firms with unspecified property rights where a community, as is the case with the TVEs, or a general bureaucracy claim quasi-ownership. Yet most firms today are based on informal partnerships (as in the IT-sector) or formal and registered (corporations) property rights regime. While the share in overall output of firms or SOEs working under an unspecified property rights regime has declined drastically in the years since the introduction of the Company Law (1994) with the result that the private sector contributed between 63 per cent and 71 per cent (collectives included) in 2003, this does not mean a complete retreat of the state sector (Economist,17.09.2005). Fieldwork (Krug and Mehta 2004; Krug and Hendrischke 2005) or case studies (Hendrischke 2003; 2005) show that bureaus, i.e. branches of national bureaucracies, or local government agencies keep a minority share in even privately established companies. They receive or can bargain for a share, as firms see this a way to limit the grasp on the firm's cash flow. By doing so managers and entrepreneurs further attempt to better "align the interest" (Nee and Peng 1994) of firms with government agencies. To the extent that these agencies, as for example local government agencies, profit from firms either directly (share on profit, tax revenue) or indirectly (investment, workplace generation, increase in land value) they have an incentive to co-operate by

[5] While international organisations such as the World Bank or the OECD distinguish only between the state, collective and private sectors, assuming that the collective sector is more or less a kind of private sector, the Chinese classification system still reflects the administrative needs of its socialist past, amended by "self-employment", private business, holdings, or TVEs, joint ventures and wholly-owned foreign companies. Any empirical analysis relying on these data runs the risk of overemphasizing political factors (as for example Walder 1995; Guthrie 2005), thereby missing the impact of economic development, such as specialisation gains, market and income differentials on the change of organisational forms (Nee and Cao 1995).

offering an attractive business and investment environment. The co-operation strategy leads to lower political and procedural hazard when local agencies protect the firms' assets and contractual relations. In short, incorporating firms not only hardens property rights, at the same time it also allocates risk to specified owners.

So far the property rights and risk consideration suggest an efficient "loss-management" for firms, and indeed strong incentives for rent-seeking. Yet the spectacular success of the Chinese firms can hardly be explained without the governance that distributed the innovation rent within firms and between firms and the share- or stakeholders. In transition economies innovation is dominated by technical innovation but includes managerial skill, as for example the talent and ability to change the organisational form of firms. Firms differ with respect to the premium they offer to technical as opposed to organisation/institutional innovation as well as the premium they offer to managerial competence as opposed to capital ownership. While technical innovation is increasingly linked to the entrepreneurial rent in the private sector depending on access to venture capital, organisational innovation depends on incentive contracts with managers. On the one side there are the managers in SOEs, still tenured and paid according to the cadre/nomenclatura guidelines, who have few incentives to search for new products or productivity increasing factor combinations. On the other side there is the extensive use of crop-sharing contracts (Cheung 1969) where villages (or government agencies) as leaser and (new) managers as lessee negotiate the sharing parameter of the innovation rent (and risk) (Krug 1997, Li and Rozelle 2003; Dong *et al.* 2004). Most privatised TVEs (see overview in Li 2005) relied on management buy-outs where managers could convert their accumulated profits into shares. To dismiss this as insider trading or an indicator of corruption is to miss the point (for example Li 2005); what matters is that a governance structure was chosen which put a high premium on the innovation of managers and, by doings so helped transfer ownership to those who had been proven to be competent.

In short the development of new forms of corporate governance was initially negotiated between managers, government agencies and networks. With the expansion of capital

markets as markets for risk, registered private property rights, and the increasing use of incentive contracts for scarce managers it is not hard to predict a convergence toward incorporated firms. And indeed China's private sector today is dominated by limited liability firms. The question is rather whether there are limits to this convergence and whether these limits imply a spatial or a jurisdictional (i.e. economic regime) dimension.

To answer these questions two institutional constraints seem exceptionally important: The *expansion of markets* will lead to more choice in how to co-ordinate inter-firm activities and at declining transaction costs. Thus, localities where (more) markets function better will see a higher concentration of organisational forms that reflect pure economic considerations. On the other hand, the *socialist legacy matters* in particular with respect to firm size and sector. Former SOEs can be expected to receive more state intervention as they are concentrated in industrial sectors where the state remains in control via "shares" or regulation. Moreover, it can also be expected that former SOEs will invest in networking where political actors play a more significant role. The effect is then that localities where large (former) SOEs constitute a considerable part of the industrial structure will see less organisational and institutional innovation at the local levels, as there is not much to be gained for local government agencies and firms from co-operating. *So long as the national state protects SOEs they might be driven to the margin of markets but can still control resources* (Krug and Polos 2004). A further institutional factor which might contribute to a clustering of organisational forms is the economic regime chosen. While Arm's Length States will interfere only in case free choice leads to monopolies or cartels, the Developmental State will limit privatization and organisational form according to politically defined development plans. In the Pre-corporatist State finally, the organisational form will remain weak and depending on negotiation amongst "stake-" and not shareholders.

Networks and Networking as transaction cost saving devices

To claim without further empirical evidence that Chinese networks – labelled *guanxi*-(personal) *relations* - are unique and therefore require a completely new social science approach has obfuscated the issues with general references to cultural values. To explain how networking which indeed is widely used in China works as a transaction cost saving device, a fresh look based on empirical studies (Gold *et.al.* 1988; Wank 1996; 1999, Yang 1994) is needed.

From the point of view of individual economic actors in transition they face the alternatives of either doing something alone, *or to embark on economic activities together with others*, or to ask government agencies to provide those goods and service private economic actors find too expensive or risky to organise (Powell 1990; Coleman 1988; Ostrom 1990; Greif 1993). With ill-functioning markets and shrinking co-ordination by the old state sector, private collaboration offers a high co-operation rent and is unsurprisingly not China-specific but rather referring to the role of social capital in the transformation process (Grabher and Stark 1997b; Stark 1996; 1998; for China see for example Boisot and Childs 1988; 1996). *The effect networking has on economic outcomes depends on the internal governance, network functions, and the interaction between networks and the different layers of government agencies.*

In the Chinese version, networks are a social mechanism for co-ordinating economic activities in which *mutual trust, affinity, and norms of reciprocity limit moral hazard and define sharing rules* (Jacobs et.al.2004; Redding 1996; Hendrischke 2004; Bian 2001; Yang 1994; 2002). Networks emerge when economic actors individually or by collective consensus opt for using this form of social mechanism. Though the hard core of networks is formed by primary groups, such as the family, classmates, colleagues or friends, the scale and scope of the networks is not limited to a predefined pool of trustworthy and likeable people. This has to do with the open boundaries, and low entry and exit costs: Individual economic actors can be members of several networks. To change from one business relation or from one network to another is seen as neither a breach of contract nor a breach of loyalty. Subsequently, the sanctions for doing so remain low. When a business relation no longer offers expected returns, the relation will be “de-activated” but

not ended in the sense that both partners remain socially connected as friends, colleagues, or family members. If enough individual actors do so then a network stops functioning as a mechanism for co-ordinating economic activities, yet retains its social functions. Likewise, entry to a network works via social acceptance as trustworthy and competent, judged by the fact that an outsider is doing business with one network member.

In the language of economic sociology such networks allow smooth switching from weak to strong ties (Granovetter 1973; 1983). Individual economic actors will embark on networking when they expect that networks offer a more effective means to co-ordinate resources and activities than either the market or the discredited state bureaucracy. Individual economic actors benefit as networks help to find a "matching" business partner and turn an anonymous into a particularistic relation (Pfeffer et al. 1976; Peng and Luo 2000, an example for the labour market is given in Bian 1997). To know that one's business partner is suitable, competent and reliable means that the cost component covering relational risks can be diminished or reduced. Therefore, networks contribute to the emergence of markets when prices/values of assets and business deals become less vulnerable to moral hazard. More important in a dynamic view is the effect that prices and exchange values reflect more exclusively scarcity, marginal costs or quality, which allows employing resources at their best use and thereby contributing to overall allocative efficiency (Batjargal and Liu 2002). This interpretation stands in clear contrast to the networking equals rent seeking equals corruption view which prevails in the analysis of other transition economies (Shleifer and Vishny 1993; Cheung 1996.) These stress the incentives for a network to embark on rent-seeking activities. In a dynamic interpretation two other features are important for explaining the diversity and limit to rent-seeking. First, underperforming networks are not driven out of the market. Instead, they turn into *dormant* (Kuilman 2005) organisational forms, whose social capital or other assets can be re-activated (at low costs) should relative prices and rates of return change. Second, networks are nevertheless subject to competition. It is a form of *diffused competition* (Hannan and Carroll 1992) less steered by changes in prices (or marginal costs) of producers than by changes in attention or interest on the demand side.

In order to get and remain activated as a co-ordinating mechanism for economic activities, networks need to fulfil (economically) valuable functions. For this reason networks need to produce satisfying outcomes for their members. As fieldwork has demonstrated these functions reflect the economic initial condition and the weak institutional architecture of the business environment rather than the more technical transaction costs which refer to firm size, sectors, or technology. Networks function as institutional entrepreneurs responding to new opportunities and changes in relative prices inherent to economic exchange relations. They are established to overcome:

(i) *resource constraints* (physical assets, human capital, lack of technology) by offering a governance structure for pooling resources (Peng 2003; Krug and Polos 2004);

(ii) *institutional weakness* in form of ill-functioning markets, ill-defined property rights, and the ambiguity of the reform course by offering private property rights protection, "contractual" security, and access to market information (Wank 1999; Peng and Luo 2000; Xin and Pearce 1996);

(iii) *the public goods problem*, more precisely the lack of investment in infrastructure, market-conforming education, or the judiciary by investing and operating public utilities, private labour bureaus and vocational training, but also law and accountancy firms (Bai *et.al.* 1998). Another aspect is that networks also offer a social mechanism where hard-to-exchange information, knowledge and experience can be jointly produced and shared, and thus the "liability of newness" (Krug and Polos 2004) in the new private sector be mitigated.

(iv) *the institutional vacuum* as perceived by economic actors when they formulate concerns, if not expectations, to be negotiated with (local) administrations to jointly search for "suitable" rules and regulations (Hendrischke 2003; Oi 1995; Walder 1995).

A second requirement that needs to be fulfilled so that networks will function as economic actors is their internal governance. They need to limit free-riding, while keeping incentives for voluntary contributions in form of information sharing and co-

operativeness. As field studies have shown it is *reputation* and the system that one member vouches for the trustworthiness of the new entering member proposed which serves as an effective enforcement device (Hendrischke 2005).

It is worth mentioning that the need to fulfil these four functions is not equally distributed across China. It is rather dependent on economic conditions and the economic regime chosen. For example, in the hinterland the resource constraint can be so dominant that networks will focus on this function mainly. Likewise, in localities where an economic regime was chosen that fits the pre-corporatist model, networking for getting access to the political sector looses its value to the extent that networks are already officially part of the political process. The different functions constitute the diversity of networks that can be observed in China. Yet, networks are not exclusively locally embedded. Instead they cut across local jurisdictions either by expanding along the technical transaction cost divide when they "specialise" on co-ordinating small firms for example, or cluster in one sector by forming alliances with the different layers of government. The costs for doing so are lowest in the Pre-corporatist State while the Arm's Length State will insist on market competition. The Developmental State acknowledges if not fosters networks of a technocratic elite in charge of economic development.

Local Autonomy as a means to reduce the costs for institution building

Recalling that the Chinese reforms started when villages as quasi-owners of land offered incentive lease contracts to private households, that TVEs became the locomotive of growth in the Eighties, and that the majority of firms sees their interests best protected by embedding (registering and networking) the firms within local jurisdictions, one cannot but ask about the precise contribution of the 'local state' to economic transformation and development. Unsurprisingly the ensuing academic debates focus on central-local relations (Wong 1992: 2002: World Bank 1994), some claim that China is moving in the direction of a corporate (authoritarian) state (Unger and Chan 1995; Walder 1995), or in

the opposite direction when local government agencies and local interest groups impoverish the central state (Li 2005; Cheung 1996).

Instead of taking sides in the debate, the following insist that the precise nature of *local autonomy* needs to be analysed before wide-sweeping effects can be predicted. It is worth recalling the local autonomy in China is not generated by national legislation separating legislative power, prerogatives and use of revenues. Instead it is based on two features, a 'weak' central authority and negotiation as the dominant governance form. The notion of a weak central authority stands for a mix of intended and unintended policies. Most obviously devolution of power transferred regulatory power to local jurisdictions but they on the other hand could no longer rely on automatic transfers for balancing the budget (hard budget constraint).

The functioning of local autonomy and its contribution to overall transformation and development depends first on the governance of public-private relations within the jurisdiction, and second on the governance of inter-jurisdictional activities. To start with the former, although local autonomy in China has a resemblance to the "commons" or Jointly Owned resources (Ostrom 1990) the dominance of property rights over land (by the village) on one side and physical assets (by managers and entrepreneurs) on the other suggest another analytical tool namely to conceptualise local autonomy is a *constrained co-operation game* between local government agencies and managers (entrepreneurs) as those groups which control the resource base of a locality (following Greif 2003). Economic development and institution building therefore depends on the interaction between these two groups. Both share an interest in economic growth of the local resource base, as each benefits from overall growth. Therefore both groups have an incentive to co-operate. Each group can increase its resources by investing in the resource base and by changing the sharing parameter to the detriment of the other group. Government agencies appropriate their share via (income) taxation, land prices, direct resource control and other forms of intervention, while firms can secure a satisfying share by moving (or threaten to move) to another jurisdiction offering a better "deal", or moving into other, less controlled, lines of production (exit), or by individual contracting

over net taxes (tax base, tax rates and tax exemption) and collective bargaining. The relative bargaining position of firms is constrained by sunk costs or asymmetric information and corporate governance, while local governments need to acknowledge institutional constraints on their autonomy, more precisely interventions from superior administrative agencies. Each group can however improve its bargaining position by mobilising support both from 'above' and from below (employees or the local 'electorate', both being weak partners however).

While the interaction between the business sector and local government agencies will depend amongst other things on the functions of government agencies, their initial endowment, formal standing within the administrative hierarchy, frequency of interactions etc, and waits for a more specific analysis, what matters in the context here is the stability condition. Local autonomy will lead to a stable business environment when both local groups have no incentive to change institutions – the resource partitioning is accepted, none has an interest to mobilise support from above thus inviting intervention, and when the upper level government agencies see no reason to interfere.

In how far does local autonomy contribute to the emergence of different business systems? Undoubtedly the devolution of power and revenue sources, such as proceeds from land management and the so-called extra-budgetary funds enabled local jurisdictions to design (and finance) a specific institutional architecture. The question is then whether we can observe patterns of institutional designs which go beyond one local jurisdiction unleashing a process by which several local jurisdictions "converge" to similar governance structures. In general competition is assumed to be the driving force. As capital (and skilled) labour will move to that jurisdiction where rate of return to investment (and human capital) is highest, the shared interest of managers, firms and local government agencies will force them to imitate "good practices". Yet, competition is not dominated by market competition. The Chinese economy knows also selection by political decision making which enables higher administrative levels or national policy to safeguard firms, industries or governance structures which otherwise would be driven to the margin or disappear completely.

Yet, there are also internal processes which drive localities toward a convergence of the institutional set up. First, there is as technical-economic process by which industrial districts emerge. As known since Marshall (Marshall 1920) positive externalities when (skilled) labour and intermediate goods are pooled, and knowledge is shared leads to the concentration of certain industries. Thus, the building up of supply chains, firm-financed training, and sharing of market-specific knowledge, but also the increased frequency of dealing with firms in the proximity, asks for an institutional setting whose boundary exceed those of one city district or township. New regional centres appear, such as the Pearl River Delta or the Lower Yangtze Delta where firms, but also local government agencies ask for better "harmonization" of rules and regulation. Second, the emergence of regional business systems can as argued earlier also be network-driven, revealing shared business practices and "habits", rather than political objectives or economic incentives. Finally, the convergence of local institutions can be the product of national politics, when the centre or any other superior administrative level, intervenes. The centre can insist on the prerogative of national legislation and define sectors, and economic activities for which a national standard is defined and which will be controlled by a national bureaucracy.

The three economic regimes offer different ways to cope with local autonomy. In the Arm's Length State there will be a trend toward institutional convergence beyond the local nexus following the incentives for investors and revenue-maximising local governments. When assisted by a liberal policy acknowledging mobility of capital and scarce human capital, market integration will occur with a concentration of industries, supporting "transaction organisations[6]" and best practices which all together will lead to a standardisation via market competition. The Developmental State on the other hand will define and re-define sectors and economic activities over which the central state claims control either by a special bureaucracy or by asking local governments to act as the implementing agency. As said earlier, in this case standardization follows bureaucratic rules, which often enough reflect a political compromise. The Pre-corporatist state,

[6] Transaction organisations refer to service providers such as banks, consultancy, legal services.

finally, will lead to the broadest range of institutional arrangement where innovation takes almost an at random form depending on the constant negotiation and re-negotiation within the local jurisdiction and between government agencies, as there is no clear criteria for selection.

CONCLUSION: Paving the way for empirical research

After having identified three types of economic regimes and three cases of organisational and institutional innovativeness which together shape the different business systems that can be observed in China, the empirical question is: Do we observe patterns of innovation? Do these innovation – any of which or all three together – concentrate on specific economic activities, sectors, or, indeed, regions? Conventional transaction costs economics (Williamson 1985) would expect that a concentration of economic activities and sectors reflect firm- and contract specific transaction costs. A geographical concentration, however, points to transaction costs which reflect high procedural uncertainty and missing private property rights. In this case to link patterns of innovation to economic regimes helps to assess to which extent the latter facilitate the general level or kind of innovation. If such a link can be established then it can be substantiated that institutional factors (at least partly) explain the heterogeneity in China's business system.

In a dynamic view the three organisational and institutional innovations can be seen as *hybrid organisations* which emerge when socialist planning no longer and market co-ordination not yet functions. Some hybrids emerge with increasing income and wealth when property rights protection becomes an issue, but will not be nationwide enforced, or when increasing private production expands beyond the local nexus asking for nationwide functioning co-ordination mechanism, such as networks. In the context of economic transformation the question is whether these hybrids will disappear with further increases in income and further market expansion. One assumption is that jurisdictional competition, i.e. imitation of better performing business systems) will cause a switch from hybrids to market institution. Yet, as has been shown earlier (tab. 1), the chosen

economic regime can either facilitate or hinder this kind of convergence. Once more to link different business systems to different economic regimes of different income levels can help to gain insights in the overall effect of chosen economic regime and organisational and institutional innovation.

REFERENCES

Aldrich, H. (1999) *Organizations Evolving*. London: Sage

Aoki, M. (2001), *Toward a Comparative Institutional Analysis*. The MIT Press: Cambridge, MA.

Bao, S., Chang G.H., Sachs J.D. and. Woo W.T (2002), 'Geographic factors and China's regional development under market reforms, 1978-1998', *China Economic Review,* **13**, 89-111.

Baron, J.N. and Hannan M.T. (2002) 'The Economic Sociology of Organizational Entrepreneurship: Lessons from the Stanford Project on Emerging Companies'. In V. Nee and Sewdberg R. (Eds.), *The Economic Sociology of Capitalism*. Russell Sage: New York.

Batjargal, B. and Lin M. M. (2002), Entrepreneur's Access to Private Equity in China: The Role of Social Capital. Ann Arbor: University of Michigan Business School. William Davidson Institute Working Paper No. 453

Baurmann, M. (1996), *Der Markt der Tugend. Recht und Moral in der liberalen Gesellschaft.* J. C. B. Mohr: Tuebingen.

Besley, T., Coate S.T. and Lour, G. (1993), 'The Economics of Rotating Savings and Credit Associations', *American Economic Review,* **83**, 792-816.

Bian, Y. (1997), 'Bringing Strong Ties Back In: Indirect Connection, Bridges, and Job Search in China', *American Sociological Review,* **62**, 266-285.

Bian, Y. (2001), '*Guanxi* Capital and Social Eating in Chinese Cities: Theoretical Models and Empirical Analyse'. In N. Lin, K. Cook and R.S. Burt (Eds.). *Social Capital. Theory and Research*. New York: Aldine de Gruyter, 275-295.

Bickford, T.J. (1994), 'The Chinese Military and its Business Operations: The PLA as Entrepreneur' *Asian Survey,* **34**, 460-474.

Blaire, M. M. (1995), *Ownership and Control. Rethinking Corporate Governance for the Twenty-First Century*, Washington, D.C.

Blanchard, O. and Shleifer A. (2000), 'Federalism with and without political centralization: China versus Russia', *NBER Working Paper Series No. 7616*, National Bureau of Economic Research: Cambridge, MA.

Boisot, M.H. and Child J. (1988), 'The iron law of fiefs: bureaucratic failure and the problem of governance in the Chinese economic reforms', *Administrative Quarterly,* **78**, 237-273.

Boisot, M.H. and Child J. (1996), 'From fiefs to clans: explaining China's emerging economic order', *Administration Science Quarterly,* **41**, 600-628.

Brean, D.J.S. (ed.) (1998), *Taxation in Modern China*. Routledge: New York and London.

Buchanan, J. M. (1965), 'An Economic Theory of Clubs', *Economica,* **32**, 1-14.

Buchanan, J. M. and Tullock G. (1962), *The Calculus of Consent*, University of Michigan Press: Ann Arbor.

Cao, Y., Qian Y. and Weingast B. (1997), 'From Federalism, Chinese Style to Privatisation, Chinese Style', Ann Arbor: University of Michigan Business School, William Davidson Institute Working Paper, No. 126.

Cheung, S. N.S. (1969), 'Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements', *Journal of Law and Economics,* **12**, 23-42.

Cheung, S. N.S. (1996), 'A simplistic general equilibrium theory of corruption', *Contemporary Economic Policy* 14.

Coleman, J.S. (1986), 'Norms as Social Capital'. In Radnitzky G. and Bernholz P. (Eds.), *Economic Imperialism: The Economic Approach Applied Outside the Field of Economics.* Paragon House, New York, 133-144.

Di Maggio, P. J. and Powell, W.W. (1983), 'The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields', *American Sociological Review,* **48**, 147-160.

Dong, X., Bowles, P. and Ho, S.P. (2002), 'The determinants of employee ownership in China's privatized rural industry: Evidence from Jiangsu and Shandong', *Journal of Comparative Economics,* **24**, 181-201.

Frye, T. and Shleifer, A. (1997), 'The Invisible Hand and the Grabbing Hand', *American Economic Review* (Papers and Proceedings), **87**, 354-358.

Gold, T., Guthrie, D. and Wank D. (eds.) (1998), Social Connections in China. Institutions, Culture, and the Changing Nature of Guanxi. New York

Gong, T. and Feng, C. (1994), 'Institutional Reorganization and its Impact on Decentralization'. In Hao, J. and Lin, Z. H. (Eds.), *Changing Central-Local Relations in China*. Westview Press: Boulder, CO., 67-89.

Goodman, D. S. G. (1995), 'Collectives and Connectives, Capitalism and Corporatism: Structural Change in China', *The Journal of Communist Studies and Transition Politics,* **11**, 12-32.

Grabher, G. and Stark, D. (eds.) (1997a), *Restructuring networks in post-socialism: Legacies, linkages, and localities,* Oxford University Press: Oxford.

Grabher, G. and Stark, D. (1997b), 'Organizing Diversity: Evolutionary Theory, Network Analysis, and Post-Socialism', *Regional Studies*, **31**, 533-544.

Granovetter, M. (1973), 'The Strength of Weak Ties', *American Journal of Sociology* **78**, 1360-1380.

Granovetter, M. (1985), 'Economic Action and Social Structure: The Problem of Embeddedness', *American Journal of Sociology*, **91**, 481-510.

Granovetter, M. (1983), 'The Strength of Weak ties: A Network Theory Revisited', *Sociological Theory*, **1**, 201-233.

Greif, A. (1998), 'Self-enforcing Political Systems and Economic Growth: Late Medival Genoa'. In R.E.A.Bates (Ed*.) Analytical Narratives,* Princeton University Press: Princeton, NJ, 23-63.

Greif, A. (1993), 'Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders Coalition', *American Economic Review,* **83**, 525-548.

Guthrie, D. (1999). *Dragon in a Three-Piece Suit: The Emergence of Capitalism in China.* Princeton University Press: Princeton.

Guthrie, D. (2005). 'Organisational Learning and Productivity: State Structure and Foreign Investment in the Rise of Chinese Corporations', *Management and Organization Review,* **1**, 165-195.

Halpern, D. (2005), *Social Capital*, Polity Press: Cambridge.

Hannan, M. and Carroll, G. (1992), *The Dynamics of Organisational Populations*, Oxford University Press: Oxford.

Hellman, J. and Schankerman, M. (2000), 'Intervention, corruption and capture: the nexus between enterprise and the state', *European Bank for Reconstruction and Development, Working paper* No. 58: London.

Hendrischke, H. (2003), 'How local are local enterprises? Privatization and translocality of small firms in Zhejiang and Jiangsu', *Provincial China,* **7**, 27-39.

Hendrischke, H. (2004), 'The Role of Social Capital, Networks and Property Rights in Chinas Privatization Process'. In B. Krug (Ed.) *China's Rational Entrepreneurs: The Development of the New Private Business Sector*. Routledge: London, 97-118:

Hollingworth, J.R., Schmitter, P.C. and Streeck, W. (1994), 'Capitalism, Sectors, Institutions, and Performance'. In Hollingsworth, Schmitter, J. R., P. C. and Streeck W. (Eds.), *Governing Capitalist Economies. Performance and Control of Economic Sectors.* Oxford University Press: New York and Oxford, 3-16.

Jacobs, G, Belschak F. and Krug, B. (2004), 'Social Capital in China: the Meaning of Guanxi in Chinese Business'. In Krug B. (Ed.), China's Rational Entrepreneurs**.** The development of the new private business sector. Routledge: London, XXXX

Krug, B. (1999), 'On custom in economics: the case of humanism and trade regimes', *Journal of Institutional and Theoretical Economics*, **155**, 405-428.

Krug, B. (1997), 'Privatisation in China: Something to learn from?'. In Giersch, H. (Ed.) *Privatisation at the Turn of the Century*, Berlin: Springer, 269-293.

Krug, B. (2002), 'Norms, Numbers and Hierarchy', *American Journal of Economics and Sociology*, **61**, 555-562.

Krug, B. (ed.), (2004) *China's Rational Entrepreneurs. The development of the new private business sector.* Routledge: London.

Krug, B. (2006 forthcoming) 'Enterprise Ground Zero in China'. In Krug, B. and Hendrischke, H. (Eds.) *China in the 21st Century: Economic and Business Behaviour. London: Edward Elgar*

Krug, B. and Mehta, J. (2004), 'Entrepreneurship by Alliance'. In Krug, B. (Ed.) *China's Rational Entrepreneurs. The development of the new private business sector.* London: Routledge, 50-71.

Krug, B. and Hendrischke, H. (2003), 'China Incorporated: Property Rights, Privatisation, and the Emergence of a Private Business Sector in China,' *Managerial Finance*, **29**: 32-45.

Krug. B., Zhu, Z. and Hendrischke, H. (2004), 'China's emerging tax regime: Devolution, fiscal federalism, or tax farming?', ERASMUS RESEARCH INSTITUTE OF MANAGEMENT, ERIM Report Series reference number ERS-2004-113-ORG

Krug, B. and Hendrischke, H. (2005), 'Entrepreneurship in Transition: Searching for Incentives and Governance in China's Private Sector'. In EGER, Th. (Ed*.), Das Ethische in der Oekonomie.* Festschrift fuer Hans Nutzinger. Marburg: Metropolis.

Krug, B. and Polos, L. (2004), 'Emerging Markets, Entrepreneurship and Uncertainty: The Emergence of a Private Sector in China'. In Krug, B. (Ed.), *China's Rational Entrepreneurs*. *The development of the new private business sector,* Routledge: London, 72-96.

Kuilman, J. (2005), *The Re-Emergence of Foreign Banks in Shanghai. An Ecological Analysis,* ERIM, Erasmus University of Rotterdam, ERIM PhD series, 66: Rotterdam

Lan, Z. (2001), 'Understanding China's Administrative Reforms', *Public Administration Quarterly,* **24**, 437-468.

Leibson, D. and Zeckhauser, R. (1998), 'Amos Tversky and the Ascent of Behavioral Economics', *Journal of Risk and Uncertainty,* **16**, 7-47.

Li, H. and Rozelle, S. (2003), 'Privatizing Rural China: Insider Privatization, innovative contracts, and the performance of township enterprises', *China Quarterly*, **176**, 981-1005.

Li, P.P. (2005), 'The Puzzle of China's Township-Village enterprises: The Paradox of Local Corporatism in a Dual Track Economic Transition', *Management and Organization Review*, **1**, 197-224.

Litwack, J.M. (2002), 'Central control of Regional Budgets: Theory with Applications to Russia', *Journal of Comparative Economics,* **30**, 51-75.

Lucas, R. E. (1986), 'Adaptive Behavior and Economic Theory'. In Hogarth, R.M. (Ed.), *Rational choice: The contrast between economics and psychology,* University of Chicago Press: Chicago and London, 217-42.

Mueller, D.C. (1989)*, Public Choice II*. Cambridge University Press: Cambridge.

Nee, V. (2000), 'The role of the state in making a market economy', *Journal of Institutional and Theoretical Economics,* **156**, 66-88.

Nee, V. and Peng, L.. (1994), 'Sleeping with the Enemy: A Dynamic Model of Declining Political Commitment in State Socialism', *Theory and Society,* **23**, 253-296.

Nee, V. and Cao Y. (2004), 'Market Transition and the Firm: Institutional Change and Income Inequality in Urban China', *Management and Organization Review,* **1**, 23-56.

Nelson, R.R. (1994), 'Evolutionary theorizing about economic change'. In Smeltser, N.J. Neil, J. and Swedberg, R. (eds.), Princeton University Press: Princeton NJ.

North, D. C. (1984), 'Transaction Costs, Institutions, and Economic History', *Journal of Institutional and Theoretical Economics,* **140**, 7-17.

North, D. C. (1990), Institutions, Institutional Change and Economic Performance. Cambridge University Press: Cambridge.

North, D. C. (2005), *Understanding the Process of Economic Change*. Princeton University Press: Princeton.

Oates, W.E. (1972), *Fiscal Federalism,* London: Harcourt Brace.

Oi, J. C. (1995), 'The Role of the Local State in China's Transitional Economy', *The China Quarterly,* **144**, 1132-1149.

Olson, M. (1965), *The logic of collective action*. Cambridge University Press: Cambridge, MA.

Ostrom, E. (1990), *Governing the Commons*. Cambridge University Press: Cambridge.

Pfeffer, J., Salancik G. and Leblebichi, H. (1976), 'The Effect of Uncertainty on the Use of Social Influence in Organizational Decision Making', *Administrative Science Quarterly*, **21**, 227-245.

Peng, M. and Luo, Y. (2000), 'Managerial Ties and firm Performance in a Transition Economy: the Nature of a Micro-macro Link', *Academy of Management Journal*, **43**, 486-501.

Powell, W.W. (1990), Neither Market nor Hierarchy: Network Forms of Organizations. *Research in Organizational Behaviour,* **12**, 295-313.

Qian, Y. (2000), 'The Process of China's Market Transition (1978-98): The Evolutionary, Historical, and Comparative Perspectives', *Journal of Institutional and Theoretical Economics,* **156**, 151-171.

Qian, Y. and Weingast, B. R (1997), 'Federalism as a Commitment to Preserving Market Incentives', *Journal of Economic Perspectives,* **11**, 83-92.

Redding, S.G. (1990), *The Spirit of Chinese Capitalism*. Berlin, New York: de Gruyter Press.

Romer, P. M. (1986), 'Increasing Returns and Long Run Growth', *Journal of Political Economy,* **94**, 1002-37.

Schlicht, E. (1998), *On Custom in the Economy*, Clarendon Press: Oxford.

Schmitter, P.C. (1974), ‘Still the Century of Corporatism?’. In PIKE, F.B. and STRITCH, D.T. (Eds.), *The New Corporatism: Social-Political Structures in the Iberian World*, University of Notre Dame Press: Notre Dame.

Scott, W. R. and Meyer, J.W. (1992), 'The organization of societal sectors'. In Meyer, J.W. and Scott, W.R. (Eds.) *Organizational environments: Ritual and Rationality*. Newbury Park, CA: Sage: 129-153.

Shleifer, A. and Vishny, R.W (1993), ‘Corruption’, *National Bureau of Economic Research, NBER Working Paper* No. 4372.

Shleifer, A. and. Vishny, R.W (1994), ‘Politicians and firms’, *Quarterly Journal of Economic,* **109**, 995-1025.

Shleifer, A. and Vishny, R.W. (1998), *The Grabbing Hand,* Harvard University Press: Cambridge, MA.

Smyth, R. and Inder, B. (2004), ‘Is Chinese Provincial Real GDP Per Capita Nonstationary? Evidence from Multiple Trend Break Unit Root Tests’, *China Economic Review,* **15**, 1-24.

Stark, D. (1996), ‘Recombinant Property in East European Capitalism’, *American Journal of Sociology,* **101**, 993-1027.

Stark, D. (1998), *Post-socialist Pathways: Transforming Political and Property in Eastern Europe,* Cambridge University Press: New York.

Thaler, R. (1991), *Quasi-Rational Economics,* Russell Sage: Cambridge, MA.

The Economist, 17.09.2005

Tiebout,C. M. (1956), 'A Pure Theory of Local Expenditure,' *Journal of POlitical Economy*, **64**, 416-24.

Tilly, C. (2001), ‘Welcome to the Seventeenth Century’. In Di Maggio; P. (Ed.), *The Twenty-First-Century Firm. Changing Economic Organization in International Perspective,*. Princeton University Press: Princeton and Oxford, 200-207.

Unger, J. and Chan, A. (1995), ‘China, corporatism, and the East –Asian mode’, *The Australian Journal of Chinese Affairs,* **33**, 29-53.

Vickers, J. and Yarrow, G. (1991), ‘Economic Perspectives on Privatisation’, *Journal of Economic Perspectives,* **5**, 111-132.

Walder, A.G. (1995), ‘Local governments as industrial firms: An organizational analysis of China’s transitional economy’, *American Journal of Sociology,* **101**, 263-301.

Wank, D. L. (1999), 'Producing Property Rights: Strategies, Networks, and Efficiency in Urban China's Non state Firms'. In Oi, J.C. and Walder, A.G. (Eds.), *Property rights and Economic Reform in China*. Stanford, CA: Stanford University Press, 264-267.

Wank, D. L. (1996), 'The Institutional Process of Market Clientelism: Guanxi and Private Business in a South China City', *The China Quarterly,* **147**, 820-838.

.

Whitley, R.D. (1999), *Divergent Capitalism: The Social Construction and Change of Business Systems*, Oxford: Oxford University

Williamson, O. E. (1985), *The Economic Institutions of Capitalism,* Macmillan: New York/ London.

Williamson, O. E. (1993), 'Calculativeness, trust and economic organization,' *Journal of Law and Economics* 36: 453-86.

Witt, U. (2000), 'Changing cognitive frames – changing organizational forms: An entrepreneurial theory of organizational development,' *Industrial and Corporate Change* 9: 733-755.

Wong, C.P. (1992), 'Fiscal Reform and Local Industrialization', *Modern China,* **18**, 197-222.

Wong, C.P. (2002), 'China. National Development and Sub-national Finance', *World Bank Report* No. 22951.

World Bank (1994), *China: Country Economic Memorandum, Macroeconomic Stability in a Decentralised Economy*. World Bank: Washington, DC.

Xin, K.R. and. Pearce, J.L (1996), 'Guanxi: Connections as Substitutes for Formal Institutional Support', *Academy of Management Journal*, **39**, 1641-1658.

Xu, Y. (2001), 'Forecasting Labor Supply in Urban China: Integrating Demographic Dynamics and Socioeconomic", *Transition Interim Report* Number: 00-01

Yang, M.M. (1994), *Gifts, Favors, and Banquets: The Art of Social Relationships in China*. Cornell University Press: Ithaca, NY:.

Yarrow, G. (1998), 'A Theory of Privatization, or Why Bureaucrats are still in Business", *World Development,* **27**, 169-200.

Zhu, Z. and Krug, B (2004) **'**Central Unification versus Local Diversity: China's Tax Regime, 1980s-2000s**',** *ERIM Report Series Reference No. ERS-2004-089-ORG*. http://ssrn.com/abstract=590193

Publications in the ERIM Report Series Research* in Management

ERIM Research Program: "Organizing for Performance"

2006

IPRs, Technological Development, and Economic Development
Wilfred Dolfsma
ERS-2006-004-ORG
http://hdl.handle.net/1765/7301

Institution Building and Change in China
Barbara Krug and Hans Hendrischke
ERS-2006-008-ORG
http://hdl.handle.net/1765/7331

Rational Entrepreneurship in Local China: Exit Plus Voice for Preferential Tax Treatments
Ze Zhu, George W.J. Hendrikse and Barbara Krug
ERS-2006-010-ORG
http://hdl.handle.net/1765/7577

A Process Model of Locational Change in Entrepreneurial Firms: An Evolutionary Perspective
Erik Stam
ERS-2006-014-ORG
http://hdl.handle.net/1765/7633

Starting Anew: Entrepreneurial Intentions and Realizations Subsequent to Business Closure
Veronique Schutjens and Erik Stam
ERS-2006-015-ORG
http://hdl.handle.net/1765/7638

Agglomeration Economies and Entrepreneurship in the ICT Industry
Frank G. van Oort and Erik Stam
ERS-2006-016-ORG
http://hdl.handle.net/1765/7639

Renascent Entrepreneurship
Erik Stam, David Audretsch and Joris Meijaard
ERS-2006-017-ORG
http://hdl.handle.net/1765/7640

Social Life of Values
Slawomir Magala
ERS-2006-019-ORG
http://hdl.handle.net/1765/7645

Enterprise Ground Zero in China
ERS-2006-024-ORG
Barbara Krug

Framing China: Transformation and Institutional Change
ERS-2006-025-ORG
Barbara Krug and Hans Hendrischke

∗ A complete overview of the ERIM Report Series Research in Management:
https://ep.eur.nl/handle/1765/1

ERIM Research Programs:
LIS Business Processes, Logistics and Information Systems
ORG Organizing for Performance
MKT Marketing
F&A Finance and Accounting
STR Strategy and Entrepreneurship