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

Enterprise Ground Zero in China

Barbara Krug

ERIM REPORT SERIES *RESEARCH IN MANAGEMENT*	
ERIM Report Series reference number	ERS-2006-024-ORG
Publication	June 2006
Number of pages	37
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 claims that the analysis of the private business sector needs to concentrate on entrepreneurship. Based on fieldwork the paper proceeds by describing how Chinese entrepreneurs perceive the (economic) problems whose solutions pre-determine the economic performance of new firms. Entrepreneurship takes the form of institution building by which the high transaction costs can be mitigated and the value of assets and contracts be protected. The empirical research identified corporate governance, incentive contracts, local autonomy and networking as the crucial "hybrids" for mobilising investment and limiting moral hazard.
Free Keywords	Entrepreneurship, Chinese Business Sector, Local Autonomy, Networking
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

Enterprise Ground Zero in China

Barbara Krug
EUR, Rotterdam and UTS, Sydney

Chapter 3 in: Barbara Krug and Hans Hendrischke (eds.) China's Economy in the 21st century: Enterprise and business behaviour. London: Edward Elgar (2006)

Abstract: The paper claims that the analysis of the private business sector needs to concentrate on entrepreneurship. Based on fieldwork the paper proceeds by describing how Chinese entrepreneurs perceive the (economic) problems whose solutions pre-determine the economic performance of new firms. Entrepreneurship takes the form of institution building by which the high transaction costs can be mitigated and the value of assets and contracts be protected. The empirical research identified corporate governance, incentive contracts, local autonomy and networking as the crucial "hybrids" for mobilising investment and limiting moral hazard.

JEL: O57, P3, P48, P57, Z13

Keywords: entrepreneurship, Chinese business sector, local autonomy and networking

Without private firms there would be no business sector in China. Yet, without entrepreneurs there would be no private firms. Entrepreneurship is also needed when state firms are privatised where new ideas are needed for re-combining productive factors, searching for new products or more efficient techniques.

Yet which kind of economic activities are best organised via competitive firms and which ones are being left to market exchange or state provision does not follow pure "technical" considerations. Instead aside from investing in an organisational form identifiable as a firm, entrepreneurs need also to invest in organisations or institutions which facilitate private exchange between and among investors, business partners, and government agencies. Entrepreneurs do not form one social group that can be defined by socio-demographic factors neither is entrepreneurship an "exogenous" factor. Entrepreneurs emerge as social agent or economic actors depending on institutional change; one that rewards risk taking, competence and "good management" (North 2005). Part of the required institutional change is political as only the political centre can give up state control over resources and the comprehensive regulatory power over economic decision making. Another part of institutional change is the outcome of the interaction between government agencies, entrepreneurs and the (emerging) markets. Whether the resulting new forms of organising production and exchange outside state control and beyond the reach of the inherited political elite (state and Party cadres) is regarded as informal or illegal, is still decided by government agencies. In other words, new institutions that might evolve spontaneously as the outcome of the interaction between markets, entrepreneurs and (local) government agencies, need to fulfil two requirements if they should become a feature of the emerging business system: First, in order to facilitate economic transformation they need to contribute to the expansion of private exchange in order to increase allocative efficiency. Second, they need to align the interests of the economic with the interests of the political interests in order to ensure the latter's compliance with the reform course and the organisational innovations at and around the firm level. That allocative efficiency in form of a functioning price mechanism is a meaningless concept so long as competitive markets are missing is self-evident. Instead economic transformation asks for a dynamic perspective where the move toward more allocative efficiency is assessed by the *expansion of markets*, more precisely the expansion of private, voluntary exchange. Ever since North institutional change facilitating market development, is captured by the concept of transaction costs. It is worth stressing that these transaction costs differ from the Williamson-type in so far that the latter refer to relation- or contract specific costs in a "market economy";

while the former reflect weak institutions caused in China by missing private property rights and the co-existence of a socialist sector and (nascent) markets.

These considerations shaped the research whose findings will be presented in what follows. First, for analysing the emergence of the new business sector in China, it is necessary to focus on entrepreneurship while firms are regarded as the outcome of institutional change. Irrespective whether new firms, i.e. greenfield investment, or a privatised firm in both cases entrepreneurship is needed. Second, analysing the emergence of a business sector needs to include all economic activities around firms, of which business relations between firms, and the relationship between firms and (local) government agencies are the most crucial. The question *which new institutions and organisations (type of firm) emerged in China caused by which factors and to which effect* asked for a special method. Following Greif (1993) this concept can be called *analytical narrative.* With the help of interviews and life histories of firms we "generated" a pool of information with respect of new organisations and institutions. In a second step we used the analytical tool kit as developed by New Institutional Economics to assess whether we can economically explain why these organisations and institutions emerged.

On methodology

The following can best be described as *analytical narrative* in which interviews provide the raw data for theorizing on the emergence of a business sector. The basic question was "How do economic actors perceive and react to opportunities and restrictions when they embark on "private" production and exchange?" The conceptual frame for the research is provided by the insights of Institutional Economics when we ask about incentives offered and restrictions imposed by formal and informal institutions, as well as the individual solutions for the economic problems around the attempt to establish and operate firms. The term Institutional Economics is chosen as a matter of convenience only and certainly does not do justice to all the approaches which turned out to be useful in explaining the behaviour of Chinese entrepreneurs, such as transaction cost economics, contract- and organisational theory, New Institutional Economics in its narrow (North) sense or part of evolutionary economics. What these approaches have in common is that they use behavioural assumptions and concentrate on institutions and their development.

The interviewees are managers and owners who attempted and succeeded in establishing a company. In the last two years representatives of tax bureaus or financial departments of local governments were added to the list of interviewees. These *"political entrepreneurs", i.e. those in charge of recombining positive and negative incentives at the political level* (Crouch 2005) are interviewed to gain more insights into the interaction between the new business and the political sector when it became obvious that this interaction is decisive for the emergence of a business environment at the local level.

Taking into account the size and heterogeneity of China any attempt to offer general findings must fail. *All analysis based on fieldwork or interviews show a strong local bias limiting the scope, if not quality, of the findings offered*[1]. To avoid this kind of over-generalisation, the "landscape" needs to be described. The term landscape here stands for the location where the interviews were organised and serves (also) as a proxy for the average income level, or different institutional frames. The landscape as described below defines the explanatory power of our findings, i.e. the scope of generalisation. We regard this as a more rigorous attempt to explain economic behaviour in China as such a procedure invites a comparative study in other parts of the country, and eventually a better empirical base for predicting whether China will end up with one integrated business system.

(1) *Interviewees*: The interviews occurred during the period 1998 to 2004. As the research focused on private, domestic firms, those companies which turned out to be a joint venture partner, a State Owned Enterprise (SOE), or not independent (in an accountancy, or profit recording sense) were later excluded. Likewise, the interviews 2003-2004 with representatives of the local and national tax bureaux were also kept separately. Thus, all in all the findings rely on 104 interviews with managers and owners, plus 15 (hard to separate) interviews with tax authorities.

(2) *Location*: The interviews cover three provinces: Shanxi, Zhejiang and Jiangsu with the latter two clearly dominating. In other words: the features of the emerging business system are based on the information from one of the richest regions in China.

(3) *Size of firms*: Although the interviews cover a broad variety of firms ranging form a "head hunter" (one owner and one secretary) to a machine tool firm employing one thousand employees, the sample is dominated by "middle scale" firms, those which employ between 25 and 200 People. To classify the firms according to turnover is

(still) a problem. In many cases the interviewees either did not know, or were unwilling to disclose the figure.

(4) *Age*: The firms are young, predominantly established after the middle of the nineties, if the date when they were registered is taken as the starting point. They were on average six years old when the interview occurred. As the life history of the firms reveals however, "Greenfield investment" is rare and concentrated in "modern" (IT or service-sector) industries in the two southern provinces. Half of the firms grew out of collective firms such as "township and village enterprises" (TVEs) or developed from independent companies set up by big state firms (SOEs). As a consequence of mixed information there is an arbitrary element in the classification of firms, more precisely about when to regard a firm as non-state and therefore keep it in the sample.

(5) *Industries*: Unexpectedly we encountered problems with classifying firms according to sector. The question about the "core business" often enough could not be answered. In this situation we learned how many firms work in different, unrelated sectors and do not see many advantages from concentrating on one sector. Once more the registration was taken as a guideline. Unsurprisingly the light industry sector, such as textile and IT played a prominent role in the two southern provinces, while in Shanxi machine tool manufacturing such as bearings and fittings and transport linked industries (trucks, or tyres) dominated.

We are interested in conceptual problems, namely to which the extent can the behaviour of Chinese entrepreneurs be explained by Institutional Economics, and the empirical problem, namely to which extent can the behaviour of Chinese entrepreneurs be explained by "rational" choice and systematic reactions based on economic considerations to changing institutions. Therefore the emphasis is on *common* features, i.e. those that can be found in different localities or industries and which seem to indicate "salient" features in the three locations where the interviews were organised. As said before our generalisations reflect the experience in three provinces only. Yet, in a dynamic view the findings could well go beyond the provincial boundaries. It is far ore likely that a province such as Jiangsu one of the richest and most developed provinces will serve as a benchmark and be imitated than a rather backward province such as Gansu or Jiangxi for example.

The remaining of the chapter is organised as follows: After discussing the specific features of the Chinese economic-political environment, which generates the incentives and constraints

for entrepreneurship, the analysis will concentrate on four China-specific responses. First, local embeddedness as a means for (informally) protecting investment and business agreements, as well as for mobilising resources; second, property rights and performance (crop sharing) contracts as means to mobilise investment and secure steady input of social capital; third, governing social capital via (a) the formal institution of local autonomy and (b) the informal institution of networking. Each section starts with a description of a common feature of entrepreneurship in China to be followed with a description how an economic analysis explains the observed behaviour, organisational "innovation" or change.

As Chinese entrepreneurs often enough define themselves as somebody searching for solutions for the (economic) problems in the "present situation", the first step in the analysis is to describe the external environment as seen from the perspective of entrepreneurs.

The external environment: uncertainty and the newness of private exchange

In general terms institutional change in China can be described by the retreat of the Party-State from economic activities, by liberalisation, de-regulation, increased foreign trade and the transfer of state-controlled assets to private actors. So far the reforms follow the general trend in other transition economies. However, three features make the Chinese reform policy unique. First the Chinese Communist Party still claims to (be able to) steer economic and social development. There was no "regime-change" in 1978. Instead the reforms reveal an incremental change process reflecting political bargaining between different layers of government or Party organisations rather than a more cautious over all development plan. Second, the reforms did not start with the (constitutional) guarantee of private ownership. Instead private property rights appear (in 2004) as a *by-product* of the development of a private business sector. Third, enterprise reforms started with decentralisation by which resource control and regulatory power were transferred to "local" levels of government.

The discussion about the advantages or disadvantages of the Chinese approach as opposed to the "big bang"-approaches of other transition economies is far from being concluded. Here it suffices to point out that Chinese entrepreneurship seriously challenges the claim that only private property rights are able to mobilise investment and commitment necessary for the

emergence of a private business sector. Apparently Chinese entrepreneurs have found ways that compensate for the disincentive of missing property rights[2].

Questions about the external environment in interviews with entrepreneurs revealed a number of trends:

1. The institutional environment is not judged by national legislation but by the whole set of national plus local legislation. Moreover, the institutional environment is not judged by proclamations or stipulations but by what is enforced. The overall picture given is one of an environment where regulations differ, change quickly and in a not foreseeable way, where informal ways supplement or contradict formal regulations, in short, where the institutional environment differs over time and across the country. Consequently, entrepreneurs will not act as "institution-takers" (in the sense of price-takers): they will not invest in strategies that help to optimise their response to any given constraint. Instead, it is assumed that the success of entrepreneurship depends on securing information about differences in and changes of regulations (and prices) *ahead of others*. To put it polemically, it is a competition for insider information reflecting the high information rent individual actors can appropriate.
2. Despite a remarkable confidence in the future and development of the reform course, entrepreneurs acknowledge the political risks involved. Although entrepreneurs and firms – unlike peasants – seem to be protected against blatant confiscation of assets, they still do need to reckon with indirect forms of confiscation which threaten the value of assets, such as compulsory mergers with (loss-making) collective or state firms or grasp on their cash flow by local tax bureaus or individual "stake holders". It is the *ad hoc* nature of this kind of state intervention, which is perceived as "being against the rules", bad administration, if not corruption, not regulation as such. Consequently, the success of entrepreneurship is seen as depending on finding ways to protect not only the value of (private) assets but also the operation and expansion of the firm needs (for a descriptive analysis of the same phenomenon in Russia see Frye 2002; Shleifer 1998).
3. Surprisingly the respondents felt much less limited by scarcity of resources, such as technology or infrastructure as the picture on the aggregate level would suggest. This was even the case in Shanxi, which at the time of the interviews lagged

> significantly behind the national average. Moreover, even when scarcity is mentioned, such as the lack of (venture) capital, managerial talent, or a skilled workforce for a modern service industry, the reaction is different from what one would expect. Instead of investing in substitutes or alternative courses of action, the reaction is to invest in "knowing the right people", that is *social capital*. So long as a still huge national and local bureaucracy or other groups control resources such as much needed financial capital, land, or export-licences, shortage appears as a distribution problem. To know the right people, or in the Chinese version: *guanxi*, is therefore a valuable asset, if not the single most crucial one when it helps to overcome other resource-constraints. The success of entrepreneurship therefore is linked to being a member of networks and investing in new networks, which might but must not include political actors.

An economic analysis of the external environment, in particular transaction cost economics and New Institutional Economics allows conceptualising the problem: The environment in China can best be summarised as one of procedural uncertainty caused by the "newness" of private business operations and the ongoing co-existence of a socialist and market sector. That there is no general knowledge about (excess) demand, price- or income elasticity of demand, let alone systematic research that would help an entrepreneur to calculate the risk of his venture, is no surprise in such circumstances. Yet, the uncertainty in China refers to a much broader set of features, connected with the newness of new business relations (Krug and Polos 2004):

There is low general level of expertise in the society at large. There is nobody to imitate, no procedure to copy, expertise cannot be easily learned with the help of formal or informal education, and neither can expertise be bought. In short, it is the newness of an organisational form, such as a private firm that poses the challenge for its founders. The newness implies further, that there is no collective memory about what can go wrong, as there is no past experience for reference. In such a situation the new organisations need to rely on general skills produced outside the organization such as formal education, or the Party *nomenklatura* system, at least until investment in organization specific training pays off (Nee 2000). Second, the new organisations need to invent roles and role relations (for new work profiles and new professions), rewards and sanctions, for which there is no blueprint available. Third, the new organisations need to build up business and social relations among "strangers" in the factor

and product markets. All in all, the need to compensate for such uncertainties takes away vital resources from the young organisational forms of private entrepreneurship, which in turn lowers their survival chances, if it does not hinder more risk-averse entrepreneurs to start a business.

The usual way economies and societies deal with behavioural is to create institutions and organisations for the purpose to "streamline" behaviour, by monitoring and sanctioning a certain kind of behaviour. In the West, business practices for example depend on contracts, private property rights, laws, the notion of liability and compensation as well as the consensus that innovation should be rewarded. In a dynamic view the effect is the following: "Institutional environments that provide general purpose safe guards relieve the need for added transaction-specific support. Accordingly, transactions that are viable in an institutional environment that provides strong safeguards may be non-viable in institutional environments that are weak - because it is not cost-effective for parties to craft transaction-specific governance in the latter circumstances." (Williamson 1993, 476).

Weakness of institutions in the Chinese context means that national legislation and national reform policies work as occasional blueprints only to the extent that they are (rarely) sanctioned effectively enough. Monitoring is infrequent and irregular contributing to rather than mitigating uncertainty (Stark 1996). To the extent that China is lacking these safeguards, procedural uncertainty translates into risk for which an appropriate premium needs to be calculated. In such a situation economic agents have a strong incentive to search for (institutional) solutions, which are more advantageous for at least some of them. While to change the overall framework of institutions might be outside the control of individual agents and rather depend on the functioning of the political market, the governance of individual transactions (private exchange) is not.

From an economic perspective this explains why Chinese entrepreneurs invest in social capital or good connections with local government agencies. *Social capital, more precisely to find and connect with people in control of scarce resources of valuable information, offers high returns when compared to other forms of capital*[3]. An economic analysis, then, further expects that economic actors search for ways that safeguard or improve the functioning of “social capital”. In order to function, governance structures should not conflict, and they should offer a "code" whose violation is connected to a specific sanctioning mechanism, that

does not tolerate observed code violations. The less economic agents violate the code and the less codes get violated the higher the level of regularity, and predictability. Thus one aspect of entrepreneurship in China can be defined as follows: *entrepreneurship refers to the ability to establish organisations and institutions that can identify and monitor key areas of "procedural uncertainty" and to search for governance structures and routines which can efficiently cope with the variance in behaviour of local government agencies or potential business partners.*

Alertness: Detecting business opportunities in transition economies

Two common features emerge from the interviews. First, entrepreneurship is best characterised by *alertness* (Kirzner 1985). To highlight the difference in what follows: in market economies alertness refers usually to radical technical innovation or global change. Successful entrepreneurship therefore, refers to someone "alert" enough to see where by "recombining" existing productive forces in a novel way, or identifying options, and (so far) underused resources net returns can be increased (Kirzner 1985, Schoonhoven and Romanellu 2001; Teece and Pisano 1994). In contrast, in transition economies, such as China, "anything sells" at the beginning of the reforms where the economy is still best described as an instant of Kornai's shortage economy (Kornai 1980). Meticulous search for novel products is as unnecessary as novel technical innovation so long as market competition is weak. Undoubtedly, this shortage of goods and the comfortable sellers' market position offers a strong incentive to establish firms, i.e. organisations able to produce larger quantities at lower costs than an individual or small household run production unit could accomplish. Entrepreneurship in this case is less focused on handling market information. Instead firms need to organise inter-firm relations and market-supporting industries and professions. Yet, first of all the political framework needs to design and safeguard institutions which mobilise and safeguard private investment, while rewarding market-conforming human capital.

The literature on entrepreneurship is, of course not unaware of the link between technical and intra-industry innovation and organisational or institutional change (Granovetter 1985; Aldrich and Fiol 1994). Whether linked to the nation state (national innovation systems: Nelson 1992), society at large (legitimation: DiMaggio and Powell 1983; Scott and 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 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.

From this perspective *entrepreneurship refers to the ability to establish organisations that can identify and monitor key resources of "volatility" and search for governance structures and routines which can efficiently cope with external shocks or the variance in behaviour of potential business partners or government agencies* (see also Casson 2005, 335). And, indeed, as the following will show entrepreneurs in China purposefully search for such governance structures.

Entrepreneurship and Corporate Governance

Seen from the point of view of entrepreneurs the establishment of firms turns into searching for efficient *corporate governance*. With no blueprint available it cannot come as a surprise that the emergence of a private business system is accompanied by experimentation and a great number of failures. As the enterprise life histories reveal, these failures remain invisible and outside the statistics as most of them result in a quick recombination of assets, change of product line, or disappearance in a "merger" with another company[4]. Despite the high variety of firms and their quick change of organisational form four common features can be singled out which characterise the existing firms (and the concerns of managers about how to proceed in the future):

1. *Ownership*. Regardless of whether non-state firms have originated in TVEs, spin-offs from SOEs (or academic institutions), or Greenfield investment, the foundation of firms reflects collective entrepreneurship caused by the need to bundle resources, in particular social capital and managerial talent, rather than individual entrepreneurship reflecting product or technical innovation. Claims to ownership are negotiated and are not limited to fixed investment at the time of the firm's establishment. Claims to ownership acknowledge social capital and an ongoing commitment once the firm has started operating. Usually firms are regarded as being "owned" by friends, local

government agencies, or networks. *In the start-up period ownership takes the form of non-contested control rights*, while income from ownership remains non-monetary and takes the form of perks, such as use of a company car, subsidised housing or banqueting.

2. *Corporate assets*. Linked to the composition of owners is the definition of corporate assets. In contrast to Western firms, corporate assets in China are not restricted to physical and financial assets (or human capital in form of patents). *Social capital is regarded as a major, if not the single most crucial corporate asset*. Likewise, corporate assets are not limited to fixed investment but acknowledge ongoing contributions in particular in the form of managerial talent, political assistance in form of favourable regulation and taxation, and the sharing of knowledge.
3. *Empowerment and routinisation*. The interviews show further that *incorporating a firm is seen as a means to empower the firm, i.e. turning the firm into a corporate actor,* which as a legal person becomes the nominal owner of corporate assets and can conclude contracts. Incorporating a firm is also a way to routinise claims to ownership, which no longer need to be negotiated on an *ad hoc* base. Finally, incorporating a firm serves the purpose of defining collaterals in order to get access to bank loans. A new trend in the prosperous region in Jiangsu and Zhejiang suggests further forms of routinisation in areas of economic activities still based on informal, social mechanism. One examples is the emergence of "advisory committees" around firms that ensure that individuals with scarce knowledge or valuable connections can be bound to the firm in a more regular way.
4. *Boundaries of the firm.* The firms of the interviewed respondents almost all reveal a weak organisational identity. Exceptions were those supplier firms which relied on long term contracts with one company, usually a SOE, such as China Telecom, or a foreign firm. Chinese owners can rarely be regarded as principals of a firm. Ownership shares are a weak predictor of control rights. Firms can also not easily be identified by a core business or a sector. As the life histories and ownership composition reveal, firms are mostly part of a network which via cross-shareholding, long term contracts or merely personnel connections controls several companies in a multitude of industries. To put it differently: networks act often as "holdings" of multi-market firms, when they choose discrete governance structures for their assets, by establishing independent firms. Although empirical data are missing, there is enough anecdotal evidence to not dismiss this feature as a local or a transitory phenomenon. *Instead,*

network by using economic and social mechanism delineate the opportunity set of a firm's economic activities, define corporate assets and therefore ultimately the boundaries of the firm.

How can one explain the underlying processes, which resulted in the common features as described so far? China's entrepreneurs reacted to the high level of uncertainty and the newness of private business relations in three ways. First, they opted for "local embeddedness" of new business ventures. Second, they employ incentive contracts as a way to mobilise investment and ongoing commitment for the joint business endeavour. Third, Chinese entrepreneurs opt for an organisational form which allows them to employ social mechanisms for aligning interests and enforcing business relations in order to harness the value of investment and the value of business relations.

1. *Local Embeddedness*

The Chinese reforms started with a large scale decentralisation by which the villages became "owners" of land, to be followed (in the nineties) by a widespread transfer of physical assets and regulatory power to local (village, county and district level) administrative units. Yet, to argue that entrepreneurs in China merely reacted to this decentralisation move when they anchored firms within a local nexus is short-sighted. Entrepreneurs regard a locality not merely as a "bundle of regulatory constraints and ad hoc state intervention".

Subsequently, from the point of view of entrepreneurs local embeddedness refers to more than the decision to establish a company at one's birthplace. Entrepreneurs do not even regard their birthplace as the resource base of first choice. Instead they will choose that locality that offers a "hospitable environment", i.e. one with which they are familiar. In such a locality they will

- Take the local labour market as a given and provide workplaces for the community by relying on a technology by which the greatest number of local labour can be employed,
- Raise capital from 'local' friends or via local institutions and decide on a product that can be sold in the local market or via local distribution channels
- Search for business information for better functioning in the local market or via local channels.

- Yet they do not feel obliged to limit the scope and scale of their economic activities to the local base. They will leave the local nexus via new investment in new subsidiaries or cross shareholding in other companies (including foreign firms) elsewhere while keeping the "headquarter" at the place of origin. They will do so when new business opportunities or a more favourable tax and regulatory regime open up elsewhere, or when the local resources base is exhausted.
- Local embeddedness seems to matter less for the younger generation of entrepreneurs, i.e. those who started a business from the end of the nineties onwards. Entrepreneurs made use of markets or market conforming institutions when this became a viable option. Thus, for example when bank loans became available to private firms, entrepreneurs started investing in collaterals needed for loans instead of further investing in good relations with representatives of local government agencies in control of "investment funds".

In an economic analysis local communities are regarded as the primary social group for collective (political or economic) decision making. The question how and why they exist is not at the core of the analysis. It is rather the question why local communities survive as an economic actors and whether they contribute to the performance (or survival) of firms. There is a broad consensus in the economic, sociological and management studies literature that local communities are the social capital producer "of last resort" generating a valuable asset often enough preceding the generation of financial or human capital, - and often enough effective enough to function as a surrogate for absent or ill-functioning markets (Greif 1993; 1998; Tilly 2001). The fact that the social capital of local (or ethnic) communities employ is often sufficient for mobilising private exchange beyond a village boundaries, but still embedded in a local (ethnic) group before and without private property rights are established make it suggestive to regard local embeddedness as a remnant of history or a phenomenon connected with the "less" developed world (literature review in Alesina 2002). Only recently did local communities (re-) gain prominence in connection with the debate on multi-layered government (in the EU, see Crouch 2005), the Comparative Business System literature (Whitley *et al.* 1996; Whitley 1999*;* Hollingworth *et al. 1994*) and within the literature on networks and local embeddedness (the classic article is Granovetter 1993, see also review in Uzzi 1996 and Borgatti and Foster 2003). It is the last stream of literature which is of interest here. In general *local embeddedness refers to the process by which social relations as structured by a locality shape economic actions.* Though local embeddedness is not a concept

that "at its own" allows the formulation of refutable propositions (Williamson 1994) it nevertheless draws the attention to specific features in economic behaviour. Despite all differences there is a broad consensus that local embeddedness offer transaction cost advantages. Whether called identity, familiarity or referred to as sharing of cultural values, local communities are characterised by a low level of opportunism. Yet, there is no "blind" trust. Beside monitoring and enforcing economic activities, local communities employ enforcement mechanism for streamlining and standardising economic behaviour. Local communities are self-enforcing organisations to the extent that information impactedness, proximity, reputation and social mechanism ensure reliability and predictability in private exchange. Trust will contribute to the performance of firms when it facilitates investment and commitment (Nooteboom *et al.* 1997). The transaction cost advantage in this case is a response to the situation-specific problem of China, namely procedural uncertainty (and liability of newness) (for Russia see Batjargal 2003; see also Alesina and La Ferra 2004).

The interviews confirm the findings in the literature. Chinese entrepreneurs react to locally induced transaction cost advantages and employ local embeddedness as a means to overcome the problem of uncertainty and liability of newness. That entrepreneurs are indeed aware of the transaction cost advantage of their home county can be seen in the following feature that marks often enough the beginning of firms: Individuals started being entrepreneurial by going to the big cities to earn cash, to be saved and used as start-up capital back in their hometown. The fact that Chinese entrepreneurship is geographically widespread, and covers rural areas finds it explanation in the transaction costs differential between place of origin and unknown or unfamiliar places.

That at the beginning of economic transformation entrepreneurs need to pool financial resources is self-evident, less attention is however paid to the need to generate and acquire knowledge and business information in order to increase the survival chance of a firm. In the sellers' market situation and at the beginning of the reform neither relative prices, changes in demand, let alone "exit" of marginal producers are reliable predictors for the relative market position of a firm. As was shown elsewhere (Geertz 1978) in such a situation of imperfect markets and asymmetric information, proximity of producers, bargaining and exchanging information is an effective means to gain valuable business information on both the customer and producer side. Thus, to start a firm within the confines of a locality is a transaction cost mitigating device.

The interviews finally reveal that local embeddedness does not forestall networking beyond the local nexus nor switching to market coordination. As will be seen presently efficient networking does indeed need to flexibly switch from strong to weak ties (Granovetter 1983), more generally to find efficient governance systems for coordinating network activities. Before this point will be taken up, the economic activities that are not co-ordinated by social relations but by contracts need to be identified and explained.

2. *Incentive contracts*

The interviews show that incentive (crop sharing) contracts are employed for

- Rewarding scarce managerial talent
- Mobilising capital including social capital around one firm
- Aligning the interests of local government agencies with the interest of a firm.

We also learned that

- The Contract Law from 1994 forces economic actors to employ standardised contracts. These however are regarded as a "soft" enforcement device only. Accompanying *oral* business agreements on the other hand are regarded as binding.
- "Trust" and contracts supplement each other. While trust-based social relations are not regarded as a substitute for business agreements, one would not embark on a business relation with somebody one does not trust.
- Business agreements are regarded as constituting long term relations. Agreements are automatically prolonged so long as no business partner objects. Conflicts are solved by renegotiation between partners and with the help of a trusted third party from the home base (Jacobs *et* al. 2004).

Incentive contracts made their first re-appearance in China when the TVEs transferred "economic responsibility" to managers of the inherited collective firms. It is worth stressing that "crop sharing" has been known since centuries in the Chinese agricultural sector (Cheung 1969a). In these contracts villages (or government agencies) act as leaser and (new) managers as lessee. The contract knows one performance independent part, i.e. a fixed salary (or rent)

and one performance dependent part. Both partners negotiate the value of the performance independent part and the sharing parameter of the innovation rent (and risk) (Krug 1997, Li and Rozelle 2003; Dong et al. 2002, 2004). As was shown elsewhere (Cheung 1969; Stiglitz 1974) the sharing parameter allocates risk. When for example the manager can claim more than fifty per cent then he gets more than the half of profit, yet has also to carry the burden in case of losses. The sharing parameter at the same time also allocates the innovation rent. In the example given above the manager would get more than a half of the profit that can be attributed to product, process or organisational innovation.

With villages being risk-averse or under-estimating the potential for innovation at the inherited technological level, these contracts were crucial for generating the first “affluent class” in China (Goodman 1994). As the interviews further reveal, none the least for tapping the household savings of managers and binding them to the firm, managers were encouraged in a second step to convert their performance-depending part of income into “options” for ownership shares. At the latest when the firms got incorporated managers could call on their options and if needed raise additional money to acquire fifty or more per cent of the company. These stories are supported by other fieldwork allowing the conclusion that this kind of management-buy out is the dominant form of privatising TVEs – and might explain the above average economic performance of the TVEs, at a time when they were still officially registered as a collective (i.e. state controlled) firm (see overview in Li 2005). Moreover, this kind of incentive contracts is also widely used in SOEs when they want to privatise part of their production range and amongst private entrepreneurs when they want to secure a long term commitment of a manager.

The use of crop-sharing contracts is also the dominant form in incorporated firms. A special form of an unwritten crop-sharing agreement is the way in which the new corporate governance acknowledges the different kinds of capital, crucial for the establishment and operation of a firm, namely financial, human and social capital. To secure the ongoing collaboration of those in control of scarce (market or political) information, valuable business contacts, or technical knowledge incentive agreements are designed which acknowledge a claim to ownership. Without immediately binding contracts the owners of social capital, as quasi-owners, can rely on compensation in form of “dividends” or access to the cash flow of a firm. Unsurprisingly the effect of such incentives is a high intra-firm consumption, if not corruption which often enough threatens the liquidity of the firm (Shleifer and Vishny 1993;

Shleifer 1998). Using firms as cash cows is not an uncommon phenomenon in China. Yet, to dismiss this as an indicator of corruption is to miss the point (for example Li 2005); what matters is that a governance structure are chosen which put a high premium on organisational innovation of managers and, by doings so helps to transfer ownership to those who had been proven to be competent.

As information, resources, and knowledge are still linked to official positions in the Party and administrative system, it cannot come as a surprise when firms "offer" incentive contracts to government agencies or individuals, thus making no difference between an individual, institutional or public "shareholder". The Chinese development of corporate governance serves as a warning not too quickly dismiss "public" ownership as a political phenomenon of a not yet liberalised economic system, or as a constrain which limits a firms in its competitive behaviour.

In short, in an economic analysis the use of contracts cannot come as a surprise. *Crop sharing contracts are a powerful institution as they offer incentives to innovate while spreading the risk* (Cheung 1969; Stiglitz 1974). The difference to the standard analysis is that in China contracting is less transaction-specific than responding to the high transaction cost generated by the procedural uncertainty and liability of newness. Thus, the economic analysis would expect that the sharing parameter as well as the relative weight of the performance independent part of the salary or income will reflect different degrees of uncertainty (and risk) in different parts of China.

Contracts are employed for mobilising capital, and for aligning interests between the business partners. This is in sharp contrast to that literature (for example Williamson 1994) where contracts are an *ex post* device for limiting opportunism, yet more in line with the literature on "hybrids" (Powell 1990) which also stresses the aspect of co-operation rents and aligning of interests. Once more the form of "contracting" reflects the external environment. Whether contracts are embedded in (local) networks, markets or a national judiciary seems also to follow transaction cost considerations. The interviews reveal that legal enforcement is dismissed by almost all entrepreneurs as being futile, too costly, if it is not regarded as counterproductive to the environment of trust on which effective networking depends. Market discipline as a way to secure contract compliance on the other hand, is seen as a valuable alternative to the effect that most entrepreneurs regret that markets are still not functioning

well enough. In short Chinese entrepreneurs carefully compare the use of the market, the judiciary and (local) networks and will embed the business agreement in that organisational form that offers enforcement most effectively or at lowest cost.

3. *The governance of social capital*

So far it has been shown that entrepreneurs attempt to turn social capital into a corporate asset by offering private property rights or incentive contracts to those in control of "good connections", information, competence or regulatory power. The entrepreneurs further start by choosing a hospitable niche, i.e. a place, which offers a lower level of procedural uncertainty thanks to proximity, familiarity, and social sanctioning mechanisms. Such a niche-strategy must limit scope and scale of entrepreneurship once local resources are exhausted. Thus, as mentioned before entrepreneurship in a dynamic view needs to *establish organisations and institutions that can identify and monitor key areas of "procedural uncertainty" and to search for governance structures and routines which can efficiently cope with the variance in behaviour of local government agencies or potential business partners.*

Unlike to what the literature claims when it is argued that the family (objected to already by Pistrui *et al.* 1999) or cultural values (in form of *guanxi*, see for example Park and Luo 2001; Peng and Luo 2000; Peng, M.2001; Peng, Y. 2004) are the backbone of entrepreneurship in China, the interviewees refer to two other institutions both of which offer a broader resource base and superior governance regime: Local autonomy and networking.

.

3.1. *Local autonomy*

The reforms, i.e. the liberalisation of markets and accompanying de-regulations did only partly succeed in de-bureaucratising the economy (Nee 2000). Entrepreneurs and firms are still restricted by (too) many regulations and the need to negotiate with local government levels. It needs to be stressed that only by interviewing entrepreneurs did we learn about the institution of tax contracts which are negotiated between economic actors and government

officials. As later interviews with representatives of the tax administration and financial departments of local government agencies confirmed, the Chinese version of *tax farming* refers *to tax contracts between the lower and higher level of government agencies, and between economic actors and local government agencies*. Tax farming (see chap.XXX) makes local governments the claimant of marginal tax revenue. After the local administrative units have fulfilled their obligation to transfer tax revenue to the national coffer and higher administrative units, they can keep (a part of) "surplus" tax revenue. In other words local governments directly profit from increasing income in their jurisdiction. Therefore they have an interest in accommodating the needs and demands of entrepreneurs.

Another rather unusual feature of the Chinese financial system is the mix between formal rules and informal negotiation. Both together constitute "local autonomy" whose economic interpretation follows the summary of our talks as seen from the perspective of entrepreneurs or the emerging business community:

- Institutional change as formulated at the national level appears in different forms of local government activities in different locations. In each case, local governments claim to follow national legislation or directives handed down from higher administrative levels, but the implementation, with very few exceptions, such as birth control policies, is locally formulated. With the notable exception of national tax administration, economic actors seldom deal directly with representatives of the central state. Instead under the specific Chinese system of so-called dual leadership, local governments are asked to implement national legislation according to local circumstances, for which purpose they coordinate their local policies with higher administrative levels, such as counties, districts, prefectures and provinces. As a result, there is no 'state' or even 'local state' as such. Instead economic actors are dealing with a variety of local governments all referring back to central policies for their legitimization, but differentiated in their policies along horizontal and vertical lines.
- Which "local state" forms the nexus of bureaucratic regulation depends on the location of firms rather then registration. Firms can be registered at the township, county, district or provincial level, depending on local industrial settlement policies and sometimes the size of firms. Yet, in the end it is the physical site of the firm which determines the level of government acting as "local state". Generally speaking

enterprises in rural areas are tied to a township, enterprises in urban areas are tied to a city district.

- Decentralisation did not only transfer regulatory power "downwards", the tax farming system further offers the financial means to execute local policy. By making tax authority partially negotiable among levels of local government, but also between local government agencies and the business community, and conferring dominant "land ownership rights" to local governments, contributed not only to the geographical inequality of income differences but also to the emergence of different business environments. In particular local governments in regions that experienced increasing land prices grew out of central budgetary control and can afford to lower overall taxes (and fees), while local government agencies in the *hinterland* relying (again) on financial transfers from the centre have less leeway to design an industrial policy (according to local conditions) (see chapt. XXX).
- Local policy formulation seen from the perspective of entrepreneurs shows in industrial settlement, regulation, taxation (and subsidisation), and is implemented in investment in complementary infrastructure and land management.
- Local financial incentives to enterprises are offered as a mix of formal and informal incentives. Only by including the informal side of taxation and subsidisation does one learn that entrepreneurs react to specific taxes or tax rates, for example tax exemptions offered, or, even more bizarre tax payment re-transferred to the tax payer. Formal tax rates by themselves remain ineffective as an allocative or sanctioning mechanism since entrepreneurs bargain for the (minimum) overall tax burden corrected by the value of appropriable subsidies, favourable land lease contracts (or land prices), or quicker access to valuable information or other bureaucratically controlled input.
- That firms are tied to a local jurisdiction does not imply that they are immobile. They can and will move out of one set of rules and taxation by moving, establishing subsidiaries (or investing in other firms) in other locations. They can also invest in other industries that offer lower taxation and less regulation.

It is hard to find another case that resembles the Chinese form of political and financial decentralisation. In particular the co-existence of a national tax system based on national legislation and implemented by national bureaucracy, and tax-farming linked to (different) layers of government unsupported by legislation that separates the tax base and mandatory tasks is rather unique. The economic analysis on Fiscal Federalism was therefore an eye-

opener for those who (still) modelled the Chinese state as a black box assuming that the central leadership controls everything. Particularly insightful and confirmed by later developments is Qian (Qian *et al.* 1995) which shows to which extent Chinese style federalism shaped the privatisation of assets and introduced the notion of jurisdictional competition, which outlines these structures for the very early stages of privatisation.

The general literature on Chinese central – local relation on the other hand either neglects the interaction between different layers of local governments (Wong 1991; Wong *et al.* 1995), or argues with a "corporatist" model (Walder 1995; Oi 1995), thus neither offering insights how the (new) interaction between entrepreneurs and the political agents are functions nor allowing a dynamic view.

The interviews suggest modelling the interaction between entrepreneurs and local government agencies as local autonomy. And indeed following Greif (2003) this interaction can be regarded as a *constrained co-operation game* between local government agencies and managers (entrepreneurs) as those two groups, which control the resource base of a locality. 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. Therefore, entrepreneurs can convert their "demand" for asset protection, contractual security, valuable business information or favourable taxation and public investment corporate governance into a corresponding supply at low costs. In return local government agencies can expect tax revenues and tax compliance. The co-operation is however constrained by the incentive to increase the share of the co-operation rent for each of the two groups to the detriment of the other. Entrepreneurs can move taxable activities outside the local jurisdiction, while local government agencies can invent new taxes, fees, or land prices. The tax farming system in an economic interpretation is then the means which allows flexibly and frequently to re-negotiate the sharing of state-private co-operation, while jurisdictional competition forces both to search for effective policies which ensure the competitiveness of the locality. While local autonomy depends on a "weak" central state a condition certainly met in China's economic and financial sector (Wong 1991; World Bank 1995, Brean 1998) both partners nevertheless can mobilise support "from above" in the negotiation game. Local government agencies can ask higher administrative levels for additional regulation entrepreneurs can use networks which go beyond the local nexus for promoting their interests.

In short Chinese entrepreneurs did indeed identify key areas of procedural uncertainty, namely the local (rather then national) jurisdiction. They contribute, if not insist on a mode of governance, i.e. tax farming contracts between individual tax payer and local government agencies, by which both partners can align their interest and better cope with the business and political risks in the external environment.

It is worth mentioning that this economic interpretation is a step forward into the direction of modelling local autonomy, formulate refutable hypotheses, embark on a comparative analysis – and thereby increase the explanatory power of the concept while better coping with China's heterogeneity.

The second new institution, and the one dominating business relations in China is networking. Though often enough overlapping with local autonomy, they are not the same. First, networks can but must not include representatives of the (local) state. Second, social capital generated at the local level and manifest in a predictable business environment is non-transferable while networks are an institution that allows entrepreneurs to embark on and govern inter-firm relations irrespective of the original local nexus.

3.2. Networking:

From the point of view of Chinese entrepreneurs networks and networking is as ubiquitous as elusive, a way of doing business they seldom question and whose functioning remains unscrutinised. It is rather by listening to Chinese entrepreneurs talking amongst themselves that one can learn the specificities. A cautious summary looks as follows (an insightful analysis is offered in chapter XXXX) :

1. Without networking nothing gets done. Networking is seen as requirement for better coping with both the bureaucracy and the market. Their claim that networking makes the market work more efficiently points less to cultural values but to the information problem (asymmetric information) nascent markets are still characterised by.
2. Networks are not clubs (or guilds). There is no fixed number of members nor is the identity of all members necessarily known. Networks can also not be defined by what

they "produce" or by their location. Entrepreneurs are not worried about the lack of organisational form of networks nor do they regard networks as being at the core of corruption *per se*. Instead they point to the effectiveness of networks which generate mobility by overcoming the fragmented markets of local jurisdictions.

3. Yet in most, if not all, cases do networks form the backbone of a firm which becomes visible at *vital events* such as liquidating a firm, mergers and acquisitions, linking up to foreign companies, incorporating a firm or use of net profit. A network member seems to be somebody whose claim to participate in the decision making process is left uncontested.
4. The functioning of networks is not restricted to co-ordinate business relations. Instead they offer the platform for sharing hard to exchange knowledge, and for learning when frequent joint meetings allow individual entrepreneurs to learn what can go wrong, what are "good practices" and to agree on certain routines. The effectiveness of such meetings has to be seen in context with the "liability of newness" which turns entrepreneurship and management into a "craft" to be learned by experience as there is no blueprint, let alone sufficient formal education, for operating private firms.
5. The governance of networks remains unscrutinised by most network members. For ensuring compliance in particular limiting moral hazard, entrepreneurs refer to the need to build up and maintain a reputation for being honest and competent as a network which in turn would cause the network to de-activate all business relations with the non-complying member, exclude him from useful knowledge sharing, if not to ostracise him (or his family).

In short, networks are an elusive organisational form whose origin, functioning, and economic consequences have led to a lively debate in the nineties with a quickly mushrooming literature (see the impressive overview in Borgatti and Foster 2003). In the China case, the argument that networks are steered by cultural norms with the consequence that their economic behaviour deviates form (rational) behaviour gained momentum at the same time yet mainly restricted to cultural studies and the management literature (Lui 1996; Luo1997; Tong and Yong 1998; Tsang1998; Lovett *et al.* 1999; Park and Luo 2001; Peng 2004).

In an economic analysis whether the network originates in cultural values (or not) matters less then their functional value and in ability to shape economic behaviour. In the Chinese version, networks are a social mechanism for co-ordinating economic activities in which *mutual trust,*

affinity, norms of reciprocity and reputation 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 primary groups, such as the family, classmates, colleagues or friends, form the hard core of networks the scale and scope of the networks is not limited to a predefined pool of trustworthy and likeable people (Hendrischke 2006). 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 an economic interpretation individual economic actors will embark on networking when they expect that networks produces "comparative advantages" which they can appropriate or at least consume. In this sense a network functions like a "collective good“ which can best be described as a reduction of the relational risk in business deals. In this sense networks, like contracting, contribute to the emergence of markets when thanks to a lower premium for relational risk, prices confer better or more market information such as scarcity, marginal costs or quality (Batjargal and Liu 2002; Bengt 1988; Lechner and Dowling 2003). In a dynamic interpretation two other features stand out: 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 subject to *diffused competition* (Hannan and Carroll 1992) competition, i.e. less steered by changes in prices (or marginal costs) of producers than by changes in attention or interest on the demand side.

The effectiveness of a network is therefore ensured by competition, reputation of a network, the fact that one network member vouches for any new one, and the repertoire of social mechanisms by which networks can sanction moral hazard**.** As in the case of local autonomy, *networks are seen as an institutional solution for identifying key areas of procedural uncertainty, namely ill-functioning markets and weak national legislation while offering a*

mode of governance, i.e. reciprocity, enforced by network sanctioning, for better coping with the business and political risks in the external environment.

In general, economic actors in China (or any other transition economy, face the alternative of either doing something alone, *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; Greif 1993). The analysis suggests to model networks as Ostrom's Jointly Owned Resources (Ostrom 1990) which would allow concentrating on the co-operation rent beyond the most general statement that with ill-functioning markets and shrinking co-ordination by the old state sector, private collaboration offers a high co-operation rent (Grabher and Stark 1997b; Nee and Stark 1989; Stark 1996; 1998; see also Boisot and Child 1988; 1996 and the interesting empirical study by Uzzi 1997). While the causes for networking seem to be straightforward, the effects point to a "hybrid" form of institution which is situated somewhere between a market surrogate (Qian 2002), a collective actor (Krug and Mehta 2004), a corporatist state (Walder 1995; Oi 1995), or a business community (Ghemawat and Karna 1998). On the one side networks contribute to allocative efficiency as individual entrepreneurs have to compete for scarce network controlled resources and to the extent that networking facilitates jurisdictional competition. On the other side, increasing (price) competition due to "excess production" and supply set incentives to embark on rent-seeking and (local or sectoral) protectionism. Finally, more empirical research is needed to clarify whether standardisation of business practices is driven by investment that rewards the best working institution and organisational form, thus contributing to the integration into one national market; or whether networks a crucial feature for the heterogeneity that can be observed in China's business practices, a feature that is more than a "hybrid" organisation but will lead to a business environment characterised by different business systems.

Conclusion:

What kind of business sector can we expect knowing how entrepreneurs respond to the environment? As a detailed analysis will be offered in chapter XXX some short remarks will suffice.

1. Unsurprisingly, *productivity increasing innovation in China comes from new entry-firms.* However, new entry firms are not necessarily established to last. Innovation centres on organisational and institutional rather than technical innovation and aims at first empowering firms so that they become corporate actors, and second increasing the efficiency of inter-firm business relations. I*ntra- and inter-firm relations will be governed by a mix of incentive contracts embedded trust-safeguarding institutions such as local communities, networks or coordinated by local autonomy*.
2. The mortality of firms reflects network considerations rather than market discipline. *Networks will close down firms irrespective of profitability if new business opportunity offers higher returns which can be realised by disassembling the assets of the existing firm and recombining such freed resources in another firm*. The mortality of firms reflects also the networks' response to asymmetric information (about markets) and (political) risks.
3. As networks enjoy discretionary power to decide the organisational form of a firm, new firms might reflect a network's decision to establish discrete governance structures for their assets, i.e. independent firm instead rather than going for big vertically integrated firms. Uncertainty and risk diversification will make them opt for a number of independent smaller multi-market companies situated in different location. *As a consequence the new business sector will see a multitude of different middle scale multi-market (Ghenawat and Khana 1998) incorporated firms connected via networks which must not be registered as owners or share holders*.
4. The individual firms are characterised by a weak organisational identity, weak boundaries and no well-defined core business. The residual control rights will be held by networks and not necessary owners;

In a dynamic view the question is what transitory organisational forms are or what can be expected to survive further economic transformation. That the relative value of social capital and therefore networking will decline is not hard to see. On one side, due to learning affects, routines will emerge which can be imitated at low costs. On the other side less uncertainty and increasing competition will destroy the comfortable sellers' market position that most firms enjoy at the moment. In that situation firms need to aim for price competition and technical innovation both asking for supplementary investment which then will cause a change in corporate assets and ownership.

Some final remark on the lessons that can be drawn from the study of entrepreneurship and the Chinese business sector for an analysis of institutional change:

1. Reforms to be successful need to increase allocative efficiency and need to align the interests of the old elite, i.e. (state) bureaucracy and party officials (Nee 2002). To insist on using an ideal type of a market system as a benchmark leaves no room for analysing institutional change that result in transitory institutions or hybrid forms of governance. Yet, we need to know more about these "hybrids", their causes and effects in order to explain which might survive and thereby adding to the variety of different forms of capitalism (Qian 2002).
2. The analysis suggests to distinguish between two forms of transaction costs, the Williamson (contract-, or relation specific) type where a market economy is regarded as given, and transaction costs which are the direct consequence of weak (market compatible) institution. Identifying the different form of transaction costs, leading to a different group of "hybrid" organisations and institutions is a necessary requirement for much needed comparative studies between different transition economies or different localities within China (as outlined already by Williamson (2000) himself).
3. China can contribute to the debate best summarised as "Primacy of property rights" versus "Primacy of exchange relations" controversy. Economic historians (see contributions in Bates 1998) have been joined by those who analyse country differences in economic development of former colonies. The latter studies also offer empirical support to the hypothesis that institutions facilitating and safeguarding private exchange can mobilise investment and commitment – a feature usually (exclusively) linked to private property rights (LaPorta *et al.*1997: Acemoglu *et al.* 2001).

References:

Acemoglu, Daron, Simon Johnson and James A. Robinson (2001), "The Colonial Origins of Comparative Development: An Empirical Investigation," *American Economic Review* 91: 1369-13401.

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

Aldrich, Howard and Marlene Fiol (1994) „Fools rush in? The institutional context of industry creation," *Academy of Management Review* 19: 645-670.

Alesina, A. (2002), "The size of Countries: Does it Matter?" *Journal of the European Association,* http://post.economics.harvard.edu/faculty/alesina/papers.html

Alesina, A. and E. La Ferra (2005) "Ethnic Diversity and Economic Performance," *Journal of Economic Literature* XLIII: 762-800.

Bates, R.E.A. (ed.) (1998) *Analytical Narratives,* Princeton University Press: Princeton, NJ.

Batjargal, B. (2003) "Social capital and entrepreneurial performance in Russia," *Organisation Studies* 2004: 535-556.

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

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

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

Borgatti, St. and P. Foster (2003), "The Network Paradigm in Organizational Research: A Review and Typology," *Journal of Management* 29: 991-1013.

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

Casson, Mark (2005), "Entrepreneurship and the theory of the firm," *Journal of Economic Behavior & Organization* 58: 327-348.

Cheung, Steven N. S. (1969a), *The Theory of Share Tenancy*. Chicago:University of Chicago Press.

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

Coleman, J.S. (1990) *Foundations in Social Theory*. Cambridge, MA: Harvard University Press

Crouch, Colin (2005), *Capitalist Diversity and Change. Recombinant Governance and Institutional Entrepreneurs.* Oxford: Oxford University Press.

DiMaggio, Paul. J. and Walter W. Powell (1983), "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields," *American Sociological Review* 48: 147-160.

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

Dong, X., Luis Putterman and B. Unel (2004), "Enterprise restructuring and firm performance: A comparison of rural and urban enterprises in Jiangsu province," William Davidson Institute Working Paper No. 668, University of Michigan, Ann Arbor.

Frye, Timothy and A. Shleifer (1997), "The Invisible Hand and the Grabbing Hand," *American Economic Review* (Papers and Proceedings) 87: 354-358.

Geertz, Clifford (1978), "The Bazaar Economy: Information and Search in Peasant Marketing," *American Economic Review*, 68: 28-32.

Ghemawat, Pankaj and Tarn Khana (1998), "The Nature of Diversified Business Groups: A Research Design and Two Case Studies," *Journal of Industrial Economics* XLVI: 35-61.

Goodman, D.S.G. (1994), "The People's Republic of China: The Party-State, Capitalist Revolution and New Entrepreneurs," In: *The New Rich in Asia:Mobile Phones, McDonalds and Middle Class Revolution*, D.S.G. Goodman and R. Robinson (eds.). London: Routledge: 225–245.

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

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

Granovetter, Mark (1993), "The Strength of Weak ties: A Network Theory Revisited", *Sociological Theory* 1: 201-233.

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

Greif, Avron (1998), "Self-enforcing Political Systems and Economic Growth: Late Medieval Genoa", in: *Analytical Narratives,* R.E.A.BATES (ed.) Princeton University Press: Princeton, NJ: 23-63.

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

Hendrischke, Hans (2004) "The Role of Social Capital, networks and Property Rights in China's Privatization Process", in: *China's Rational Entrepreneurs. The development of the New Private Business Sector.* Barbara Krug (ed.) London: Routledge, 97-118.

Hendrischke, Hans (2006), xxxx European Business Forum

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

Jacobs, Gabriele, Frank Belschak and Barbara Krug (2004) "Social Capital in China: the meaning of *guanxi* in Chinese business", in: *China's Rational Entrepreneurs. The Development of the New Private Business Sector,* Barbara Krug (ed.) London: Routledge: 166-188.

Kirzner, IsraelM. (1985), *Discovery and the capitalist process*. University of Chicago Press: Chicago

Kornai, J. (1980), *Economics of Shortage*, Vol. I and II. Amsterdam: North Holland

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

Krug, Barbara (2002), "Norms, Numbers and Hierarchy," *The American Journal of Economics and Sociology* 61:555-562.

Krug, Barbara and Laszlo Polos (2004), "Emerging Markets, Entrepreneurship and Uncertainty: The Emergence of a Private Sector in China," in: *China's Rational Entrepreneurs. The development of the New Private Business Sector.* Barbara Krug (ed.) London: Routledge: 72-96.

Kuilman, J. (2005) *The Re-Emergence of Foreign Banks in Shanghai: An Ecological Analyis.* Ph.D. Dissertation, Erasmus University.

LaPorta, Rafael, Florencio Lopez-de Silanes, Andrej Shleifer and Robert W. Vishny (1998) "Law and Finance, " *Journal of Political Economy* 106: 1113-1155.

Lechner, Christian, and Michael Dowling (2003), "Firm networks: external relationships as sources for the growth and competitiveness of entrepreneurial firms," *Entrepreneurship & Regional Development 15*: 1-26.

Li, David D. (1996). "Ambiguous Property Rights in Transition Economies: The Case of the Chinese Non-State Sector," *Journal of Comparative Economics* 23:1-19.

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.

LI, H. AND ROZELLE, S. (2003), "Privatizing Rural China: Insider Privatization, innovative contracts, and the performance of township enterprises," *The China Quarterly* 176: 981-1005.

Lovett, Steve, Lee C. Simmons, and Raja Kali (1999), "Guanxi versus the Market: Ethics and Efficiency," *Journal of International Business Studies* 30: 231-247.

Lui, Tai Lok (1996), "A Brief Note on Guanxi," in: *Asian Business Networks*, Gary G. Hamilton (ed.), Berlin: Walter de Gruyter & Co.: 385-398

Luo, Yadong (1997), "Guanxi: principles, philosophies, and implications," *Human Systems Management* 16:43-51

Nee, Victor (1992), "Organizational Dynamics of Market Transition: Hybrid Forms, Property Rights, and Mixed Economy in China," *Administrative Science Quarterly* 31:1-27.

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

Nee, V. and D. Stark (eds.) (1989), *Remaking the Economic Institutions of Socialism: China and Eastern Europe*. Stanford University Press: Stanford.

Nee, Victor and Susan Su (1996), "Local Corporatism and Informal Privatization in China's Market Transition," in: *Reforming Asian Socialism: The Growth of Market Institutions.* J. McMillan and Barry. Naughton. (eds.) Ann Arbor: University of Michigan Press.

Nelson, Richard R. (1992), *National innovation systems: A comparative analysis.* New York: Oxford University Press.

Nooteboom, Bart (1999) "Innovation, learning and industrial organizations," *Cambridge Journal of Economics* 23: 127-150.

Nooteboom, Bart (1999a), "The Triangle: Roles of the Go-Between", in: *Corporate Social Capital*. S.Gabbay and R. Leenders (eds.) Dordrecht: Kluwer Academic Publisher: 341-355.

Nooteboom, Bart., H. Berger, N.G. Noorderhaven, (1997), "Effects of Trust and Governance on Relational Risk," *Academy of Management Journal* 40, 308-332.

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

OECD (2005), Governance in China. Paris: OECD Publications

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

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

Park, Seung Ho, and Yadong Luo (2001), "Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms," *Strategic Management Journal* 22: 455-477

Peng, Mike W. and Yadong Luo (2000), "Managerial Ties and Firm Performance in a Transition Economy: The Nature of a Micro-Macro Link," *Academy of Management Journal*, 43:486-501.

Peng, Mike W. (2001), "How entrepreneurs create wealth in transition economies," *The Academy of Management Executive* 15:95-108.

Peng, Yusheng (2004), “Kinship Networks and Entrepreneurs in China’s Transitional Economy,” *American Journal of Sociology* 109:1045-1074.

Pistrui, David, Wilfred Huang, Dolun Oksoy, Jing Zhao, and Harold Welsch (1999), “The Characteristics and Attributes of New Chinese Entrepreneurs and Their Emerging Enterprises,” *Business Forum* 24:31-38

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

Qian Yingyi (2002) “How Reform worked in China,” University of California, Berkeley, Center for Economic Policy Research. **www.cepr.org/pubs/dps/DP3447.asp**

Redding, S.G. (1996), ”The Distinct Nature of Chinese Capitalism,” *The Pacific Review* 9:426-440.

Schoonhoven, Claudia B. and Elaine Romanellu (2001), ”Emergent themes and the next wave of entrepreneurshp research,” in: *The entrepreneurship dynamic.* Schoonhoven, Claudia B. and Elaine Romanellu (eds.) Stanford, CA: Stanford University Press: 383-408.

Scott, W. Richard and John W. Meyer (1992), ”The organization of societal sectors,” in: John W. Meyer and W. Richard Scott (eds.) *Orgnizational environments: Ritual and Rationality*. John W. Meyer and W. Richard Scott (eds.) Newbury Park, CA: Sage: 129-153.

Shleifer, Andrej (1998), “State versus Private Ownership, “ *Journal of Economic Perspectives* 12:133-150.

Shleifer, Andrej and Vishny R.W. (1993), “Corruption,“ Cambridge, MA: National Bureau of Economic Research. *NBER Working Paper* No. 4372.

State Statistical Yearbook of the People’s Republic of China. (2004) Oxford University Press.

Stark, David (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.

Stiglitz, J.E. (1974), “Incentives and Risk Sharing in Sharecropping,“ *Review of Economic Studies* 61:219-255.

Stiglitz Joseph E. (1991), "Government, Financial Markets, and Economic Development," *NBER* Working Paper 1991.

Tabellini, G. (2005), “Culture and Institutions: Economic Development in the Regions of Europe.“ CESifo working pasper 1492. www.Cesifo.de

Teece, David J. and Gary Pisano (1994), “The Dynamic Capabilities of firms: An Introduction,” *Industrial and Corporate Change* 3: 537-556.

Tilly, C. (2001), “Welcome to the Seventeenth Century,“ in: *The Twenty-First-Century Firm. Changing Economic Organization in International Perspective.* P. DiMaggio (ed.) Princeton and Oxford: Princeton University Press: 200-207.

Tong, Chee Kiong and Pit Kee Yong (1998), “Guanxi bases, Xinyong and Chinese business networks,” *British Journal of Sociology* 49:75-96.

Tsang, Eric W.K. (1998), “Can guanxi be a source of sustained competitive advantage for doing business in China,” *The Academy of Management Executive,* 12:64-73

Uzzi, B. (1996), “The sources and consequences of embeddedness for the economic performance of organizations: the network effect,” *American Sociological Review* 61: 674-698.

Uzzi, B. (1997), “Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness,” *Administrative Science Quarterly* 42:35-67.

Walder, Andrew G. (1995), “Local Governments as Industrial Firms: An Organizational Analysis of China’s Transitional Economy,“ *American Journal of Sociology* 10:263-301.

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

Whitley, R., J. Henderson, L. Czaban and G. Lengyel (1996) "Trust and Contractual Relations in an Emerging Capitalist Economy: The Changing Trading Relationships of Ten Large Hungarian Enterprises," *Organisation Studies* 17: 397-420.

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

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

Williamson, Oliver E. (1994), “The Evolving Science of Organization,“ *Journal of Institutional and Theoretical Economics* 149:36-63.

Williamson, Oliver E. (2000), “The New Institutional Economic: Taking Stock, Looking Ahead,” *Journal of Economic Literature* 38: 595-613.

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

Wong, C.P., Heady, C. and Woo, W.T. (1995), *Fiscal Management and Economic Reform in the People’s Republic of China.* Manila: Asian Development Bank.

Wong, C.P.W. (1991), “Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China,“ *The China Quarterly* 128: 691-715.

World Bank (1995), *China: Macroeconomic Stability in a Decentralised Economy*, Washington, DC: World Bank

Table 1

Chinese Private Sector outpaces the public sector

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**Change**
Non-farm business sector							
Private Sector	43.0	45.3	47.7	51.8	54.6	57.1	+14.1
Public Sector	57.0	54.7	52.3	48.2	45.4	42.9	-14.1
State controlled	40.5	40.1	39.6	37.1	35.2	34.1	-6.4
Collectively controlled	16.5	14.7	12.7	11.2	10.1	8.8	-7.7
Total (79% of GDP)	100.0	100.0	100.0	100.0	100.0	100.0	
Business Sector							
Private Sector	53.5	54.9	56.3	59.4	61.5	63.3	+9.8
Public Sector	46.5	45.1	43.7	40.6	38.5	36.7	-9.8
State-controlled	33.1	33.0	33.1	31.2	29.9	29.2	-3.9
Collectively controlled	13.4	12.1	10.6	9.9	8.6	7.5	-5.9
Total (94% of GDP)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Bureau of Statistics and OECD (1995) estimates

Table 2 State-owned and Non-state-owned Enterprises, 2003

Item	No. of Enterprises	GIOP, 100 million yuan
National Total	**196222**	**142271,22**
Grouped by Status of Registration		
Domestic Funded Enterprises	157641	97913,42
1) State-owned Industry	23228	18479,4
2) Collective-owned Industry	22478	9458,43
3) Cooperative Enterprises	9283	3250,9
4) Joint Ownership Enterprises	1689	948,67
a) State Joint Ownership Enterprises	296	394,72
b) Collective Joint Ownership Enterprises	486	173,24
c) Joint State-collective Ownership Enterprises	549	231,93
5) Limited Liability Corporations	26606	26583,94
a) Sole State-funded Corporations	1330	7073,68
6) Share Holding Enterprises	6313	18017,06
7) Private Enterprises	67607	20980,23
8) Other Enterprises	437	194,79
Enterprises with Funds from Hong Kong, Macao and Taiwan	21152	17425,62
Foreign Funded Enterprises	17429	26932,18
State-owned and State-holding Enterprises	34280	53407,9

Remarks: (a) refers to all state-owned industrial enterprises with annual sales income of over 5 million yuan.

(b) The Industrial statistics covers all industrial enterprises within the territory (excluding Hong, Kong, Macao and Taiwan). Since 1998, the coverage of industrial statistics was changed from types of ownership to the size of enterprises, they are: all state owned industrial enterprises and those non-state industrial enterprises with annual sales over 5 million yuan, and non-state industrial enterprises with annual sales below 5 million yuan Data by industries in the chapter are based on the 2002 National Industrial Classification of all Economic Activities, and date by size of enterprises are base on the Preliminary Standards of Enterprises by Size.

Source: State Statistical Yearbook 2004,

[1] The best-know example is Hofstede and Hofstede though in his case the bias is not linked to one location but to one firm, namely IBM. See Hofstede and Hofstede 2005.

[2] Known also as the Grabbing Hand – Helping Hand controversy. For the first hypothesis see Shleifer and Vishny 1998 , for the corporatist approach see Oi 1995 and Walder 1995. See also Hoff and Stiglitz 2002.

---

[3] Social capital, networks or embeddedness are often hard to distinguish as all three concepts refer to "social ties". In what follows social capital is seen as a resource which like other forms of capital – financial or human – once invested generates "utility" or tangible returns (Lechner and Dowling 2003; Johannisson 1988; Hitt *et al.* 2002.

[4] See below the section on networks.

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